Technical Notes to a Notice of Ways and Means Motion Relating to Income Tax

Issued by
The Honourable Michael Wilson
Minister of Finance

June 1986

Canada

Technical Notes to a Notice of Ways and Means Motion Relating to Income Tax

Issued by
The Honourable Michael Wilson
Minister of Finance

June 1986

Department of Finance Canada
Ministère des Finances Canada

These technical notes are provided to assist in an understanding of the amendments proposed to be made to the Income Tax Act and a related statute. They are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Cette publication est également offerte en français.

Centre de distribution
Ministère des Finances
160, rue Elgin
Ottawa (Ontario)
(613) 995-2855

Distribution Centre
Department of Finance
160 Elgin Street
Ottawa, Ontario
(613) 995-2855

Preface

The Notice of Ways and Means Motion contains proposed amendments to the Income Tax Act that were announced in the February 26, 1986 budget. The Notice also contains other proposed amendments to the Act including those relating to the minimum tax, the exploration tax credit, the revised definition of Canadian exploration expense and the new rules relating to carve-out arrangements.

These technical notes provide a clause-by-clause analysis of the proposed amendments and are intended to assist Members of Parliament, taxpayers and their professional advisers in understanding them. In addition, several draft income tax regulations relating to the proposed amendments are attached as appendices.

The Honourable Michael Wilson
Minister of Finance

Table of Contents

*Amendments to Bill C-84

Income from an Office or Employment

ITA
6

Clause 1

Section 6 of the Act deals with amounts to be included as income from an office or employment. This section provides for the inclusion in an employee's income of most employment-related benefits other than those specifically excluded. The amendments to this section relate to the requirement for a taxpayer to include in his employment income certain deferred amounts under a salary deferral arrangement.

The expressions "salary deferral arrangement" and "deferred amount" are defined in subsection 248(1) and are discussed in the commentary to that provision. Generally, a salary deferral arrangement is an arrangement between an employer and employee under which the employee has postponed the receipt of his remuneration beyond the end of a year and it is reasonable to consider that one of the main purposes for the postponement is to defer the tax payable by the employee in respect of his salary or wages for services rendered by him in the year or in a preceding year. The remuneration that is postponed beyond the end of a year under a salary deferral arrangement is referred to in these provisions as a "deferred amount" for a taxation year. This expression is defined in subsection 248(1) as an amount that a person has a right to receive after the year under a salary deferral arrangement. For example, if to postpone tax an employee arranges to defer receipt of 20 per cent of his annual salary of $100,000 to a subsequent year, this would be a salary deferral arrangement and the $20,000 would be the deferred amount. This will be the case whether the $20,000 is retained by the employer or contributed to a trustee or custodian for the employee's benefit. As discussed in the commentary to subsection 248(1), certain plans and arrangements are excluded from the definition of a salary deferral arrangement and there are transitional rules for existing plans or arrangements.

Subclause 1(1)

ITA
6(1)(i)

Deferred amounts under a salary deferral arrangement are required by new subsection 6(11) to be included in an employee's income as a benefit under paragraph 6(1)(a) of the Act.

New paragraph 6(1)(i) requires certain amounts actually received by any person in a taxation year under a taxpayer's salary deferral arrangement other than a trust to be included in computing the taxpayer's income for the year. The amount received in a year is included in the taxpayer's income to the extent that the aggregate of all such amounts received in the year exceeds the total of amounts included in preceding years under paragraph 6(1)(a) under the arrangement and any amounts forfeited under the arrangement that were deductible by the taxpayer under paragraph 8(1)(o). Note that this provision does not apply to amounts received out of a trusteed salary deferral arrangement, which are treated as distributions by a trust to which the ordinary rules relating to trusts in subdivision k (sections 104 to 108) apply. This new paragraph applies to the 1986 and subsequent taxation years.

Subclause 1(2)

ITA
6(11) to (14)

New subsections 6(11) and (12) of the Act provide for the inclusion in a taxpayer's income on an accrual basis of the deferred amount in respect of his salary or wages under a salary deferral arrangement. These provisions apply for the 1986 and subsequent taxation years.

New subsection 6(11) provides that, where a taxpayer has a right in a year to postpone receipt of his salary or wages to a subsequent year under a salary deferral arrangement in respect of the taxpayer, an amount equal to the deferred amount is considered to be an employee benefit received by him in the year. As such, this amount must be included in computing the taxpayer's income for the year under paragraph 6(1)(a) to the extent it has not already been included in the year or a preceding year.

New subsection 6(12) treats as deferred amounts any interest or other amounts in addition to the deferred remuneration that accrue to the taxpayer to the end of a taxation year under his salary deferral arrangement. If, for example, an employer agreed to pay interest on deferred amounts under an unfunded salary deferral arrangement, the interest accrued to the taxpayer to the end of a year will be required to be included as a benefit under paragraph 6(1)(a) in computing his income for the year. This provision does not apply to interest earned by a trust governed by a salary deferral arrangement.

New subsection 6(13) provides an exception to the rules described above for deferred amounts under a salary deferral arrangement established primarily for the benefit of non-resident employees for services rendered outside Canada. This exception extends to deferred amounts under such arrangements that are in respect of services rendered in Canada by an employee who becomes a Canadian resident for up to three years as long as the arrangement applied to him before he became a Canadian resident. This exception is similar to that provided in subsection 18(10) relating to the deduction of contributions to employee benefit plans.

In the absence of special rules, a plan or arrangement between an employer and employee might constitute both an employee benefit plan and a salary deferral arrangement. Although it is expected that these cases will be rare, since the tax treatment of each is different, it is necessary to provide rules to deal with them. New subsection 6(14) provides that where a salary deferral arrangement in respect of a taxpayer is part of a combination plan or arrangement providing other benefits, it will be treated as a separate arrangement that is not an employee benefit plan. This subsection also provides an ordering rule for payments out of a combination plan or arrangement. Payments out of any such combination plan are generally treated as having been received out of the salary deferral arrangement to the extent of prior deferred amounts that the taxpayer is considered to have received as benefits under that arrangement.

Subclause 1(3)

This provides that the amendments to section 6 relating to salary deferral arrangements are applicable to the 1986 and subsequent taxation years. However, reference should be made to the definitions of "salary deferral arrangement" and "deferred amount"in subsection 248(1) and the transitional rules that apply to these definitions.

Deductions in Computing Income from an Office or Employment

Clause 2

Section 8 of the Act permits an employee to deduct certain employment-related expenses.

Subclause 2(1)

ITA
8(1)(m.1)

Subsection 8(1) of the Act specifies the amounts that a taxpayer may deduct in computing his income from an office or employment. Existing paragraph 8(1)(m) provides that the deduction in respect of an employee's contribution to a registered pension plan in a year cannot exceed $3,500. New paragraph 8(1)(m.1) provides a deduction in a year for employee contributions to a defined benefit registered pension plan, other than voluntary contributions, in excess of $3,500 with respect to services rendered in the year. The effect of the amendment is to remove the $3,500 limit for required current service contributions under such plans for the 1986 and subsequent taxation years.

Subclause 2(2)

ITA
8(1)(o)

New paragraph 8(1)(o) of the Act provides a deduction in a year for deferred amounts that have been included in a taxpayer's income as a benefit under a salary deferral arrangement in a preceding year and which are forfeited in the year. This provision applies where the taxpayer's right to receive the deferred amount under the arrangement is subject to a condition that is not met and his entitlement is thereby extinguished. In such case, the taxpayer will be permitted a deduction if the forfeited amount was included in computing his income for a preceding year as an employee benefit under paragraph 6(1)(a). This provision is applicable to the 1986 and subsequent taxation years.

Subclause 2(3)

This provides that the amendments to section 8 are applicable to the 1986 and subsequent taxation years.

Amounts Included in Income

Clause 3

Section 12 of the Act requires the inclusion of specified items in computing a taxpayer's income from a business or property.

Subclause 3(1)

ITA
12(1)(n.2)

New paragraph 12(1)(n.2) of the Act is applicable to the 1986 and subsequent taxation years. It requires an employer, who claims a deduction under new paragraph 20(1)(oo) in computing his income in respect of a deferred amount under a salary deferral arrangement, to recapture the deduction for his taxation year in which the right of the employee or former employee to receive the deferred amount is extinguished. The reference to new paragraph 20(1)(oo) is to the provision that permits an employer to claim a deduction in a taxation year in respect of a deferred amount in the year under a salary deferral arrangement where that amount is included as an employee benefit in computing his employee's income.

Subclause 3(2)

ITA
12(1)(t)

The amount deducted from tax in respect of the investment tax credit reduces the tax basis of the relevant expenditure — that is, the undepreciated capital cost of depreciable property, the adjusted cost base of certain interests in a partnership or a trust or the amount of deductible scientific research expenditures. To the extent such reductions in tax basis do not take place, paragraph 12(1)(t) of the Act requires the amount of any credit claimed to be included in the taxpayer's income. Paragraph 12(1)(t) is amended to reflect the introduction of subparagraph 66.1(6)(b)(xi) of the Act to reduce the cumulative Canadian exploration expense of a taxpayer by the amount of any investment tax credit claimed by him with respect to qualified Canadian exploration expenditures. The amendment to paragraph 12(1)(t) ensures that the amount of such a credit claimed by the taxpayer is not included in income to the extent that it has reduced his cumulative Canadian exploration expense. This amendment is applicable on and after December 1, 1985 — the date on which the 25-per-cent tax credit for certain exploration expenses was introduced.

Subclauses 3(3) and (4)

These set out the effective dates for the amendments to section 12 of the Act. (See also clause 75 which amends the effective date for paragraph 12(1)(x), as enacted by Bill C-84.)

Prohibition of Certain Deductions

Clause 4

Section 18 of the Act prohibits the deduction of certain items in computing a taxpayer's income from a business or property.

Subclause 4(1)

ITA
18(1)(o.1)

New paragraph 18(1)(o.1) of the Act, which is applicable to the 1986 and subsequent taxation years, denies the deduction of outlays or expenses made or incurred by an employer in respect of a salary deferral arrangement except as expressly permitted under new paragraph 20(1)(oo). An exception is made for certain arrangements established primarily for the benefit of non-resident persons. An employer may claim a deduction in a taxation year under new paragraph 20(1)(oo) in respect of a deferred amount under a salary deferral arrangement that is included in computing an employee's or former employee's income. Reference should be made to the commentary on that provision.

Subclause 4(2)

ITA
18(9)(d)

Subsection 18(9) of the Act prohibits the deduction of prepaid expenses in computing income for a taxation year preceding the taxation year to which the expenses relate. Paragraph 18(9)(b) allows an amount prohibited as a deduction by paragraph (a) in one year to be deducted in the subsequent year to which the amount relates. New paragraph 18(9)(d) is added as a consequence of new subparagraph 37(1)(a)(vi) which allows a deduction for amounts paid to an approved organization that in turn pays the amounts to another organization to undertake scientific research. Paragraph 18(9)(d) provides that a payment referred to in new subparagraph 37(1)(a)(vi) will not be treated as a prepaid expense.

Thus the payment will be deductible in the year in which it is made even though the research may not be undertaken until a subsequent year. This amendment is applicable to payments made after February 25, 1986.

Subclauses 4(3) and (4)

These set out the effective dates for the amendments to section 18 of the Act.

Deductions Permitted – Business and Property Income

Clause 5

Section 20 of the Act sets out rules providing specifically for the deduction of certain outlays, expenses and other costs in computing a taxpayer's income from a business or property.

Subclause 5(1)

ITA
20(1)(gg)

Paragraph 20(1)(gg) of the Act deals with the inventory allowance. This takes the form of a deduction in computing income from a business of an amount equal to 3 per cent of the cost amount, at the beginning of a taxation year, of tangible property held for sale in the course of the business. This provision is repealed for taxation years commencing after February 25, 1986.

For taxation years that include that date, the 3-per-cent deduction must be pro-rated on the basis of the number of days in the taxation year that are before February 26, 1986.

Subclause 5(2)

ITA 20(1)(oo)

New paragraph 20(1)(oo) of the Act permits an employer to claim a deduction in respect of a deferred amount under a salary deferral arrangement that is included as an employee benefit in computing the income of his employee or former employee in respect of services rendered to the employer. The employer's deduction may be claimed in his taxation year that includes the end of the employee's taxation year in which the deferred amount was treated as a benefit. As an example, where an employer has a January 31 year-end, he may claim a deduction in his 1987 taxation year with respect to any deferred amounts as at December 31, 1986 that were required to be included in his employees' income for 1986.

The application of this paragraph, together with the other provisions relating to salary deferral arrangements, may be illustrated in the following example. Assume that under a salary deferral arrangement in respect of an employee ("EE") three amounts of $10,000 of his annual salary are deferred in Years 1 to 3, that the employer ("ER") agrees to pay interest of 10 per cent on amounts deferred and that the employee receives these deferred amounts from his employer in Year 4. Assume further that the arrangement is self-funded by the employer and does not involve a trustee or custodian.

	Deferred Salary	EE Inclusion 6(1)(a)	ER Inclusion 12(1)(n.2)	ER Deduction 20(1)(oo)	EE Receipt 6(1)(i)	EE Deduction 8(1)(o)
			(dollars)			
Year 1	10,000	11,000	—	11,000	—	—
Year 2	10,000	12,100	—	12,100	—	—
Year 3	10,000	13,310	—	13,310	—	—
Year 4	—	—	—	—	—	—
Total	30,000	36,410	nil	36,410	nil	nil

If, instead, the employee's right to the deferred amounts was forfeited in Year 4 the tax consequences would be as follows:

	Deferred Salary	EE Inclusion 6(1)(a)	ER Inclusion 12(1)(n.2)	ER Deduction 20(1)(oo)	EE Receipt 6(1)(i)	EE Deduction 8(1)(o)
			(dollars)			
Year 1	10,000	11,000	—	11,000	—	—
Year 2	10,000	12,100	—	12,100	—	—
Year 3	10,000	13,310	—	13,310	—	—
Year 4	—	—	36,410	—	—	36,410
Total	30,000	36,410	36,410	36,410	nil	36,410

In the case of a trust governed by a salary arrangement, the rules apply as in the following example. Assume the same facts as in the above example except that the $10,000 deferred amounts are contributed by the employer to a trustee (T) and, when invested, earn interest income at 10 per cent per annum.

	Deferred Salary	EE Inclusion 6(1)(a)	ER Inclusion 12(1)(n.2)	ER Deduction 20(1)(oo)	EE Receipt 12(1)(m)	EE Deduction 8(1)(o)	T Inclusion	T Deduction
				(dollars)				
Year 1	10,000	10,000	—	10,000	1,000	—	1,000	1,000
Year 2	10,000	10,000	—	10,000	2,000	—	2,000	2,000
Year 3	10,000	10,000	—	10,000	3,000	—	3,000	3,000
Year 4	—	—	—	—	—	—	—	—
Total	30,000	30,000	nil	30,000	6,000	nil	6,000	6,000

The example assumes that the interest earned by the trust was payable each year. If it was not payable, it would be taxable in the hands of the trust rather than the employee and when paid out would be treated as any other distribution of accumulated taxed income of a trust.

Subclauses 5(3) and (4)

These set out the effective dates for the amendments to section 20 of the Act.

Scientific Research and Experimental Development

ITA
37(1)(a)(vi)

Clause 6

Section 37 of the Act relates to the deduction for expenditures on scientific research and experimental development. Paragraph 37(1)(a) allows a taxpayer carrying on business in Canada to deduct certain current expenditures incurred in Canada in respect of scientific research and experimental development. This paragraph is amended to provide a deduction for payments made by a taxpayer after February 25, 1986 to an approved organization. For this purpose, an approved organization is one that has been approved by the Minister of National Revenue and will include the Natural Sciences and Engineering Research Council, the Medical Research Council and the Social Sciences and Humanities Research Council. The payments received by an approved organization must be paid by it to an association, institution or corporation described in any of subparagraphs 37(1)(a)(ii) to (iv) and used by the recipient to undertake scientific research and experimental development that relates to the class of business of the taxpayer. In addition, the taxpayer must be entitled to exploit the results of that scientific research and experimental development.

Indexed Security Investment Plans

ITA
47.1(28)

Clause 7

Section 47.1 of the Act sets out the basic rules for indexed security investment plans (ISIP's). These provisions, except for certain transitional rules, were repealed effective January 1, 1986.

New subsection 47.1(28) provides transitional rules for a taxpayer who was a participant under an indexed security investment plan on January 1, 1986. Generally, these rules permit ISIP property to be distributed to the participant thereof on a tax-free basis. Each indexed security owned under the plan on January 1, 1986 is treated as having been disposed of thereunder at that time for proceeds equal to the proportionate share of the plan's indexing base that the fair market value of that security bears to the fair market value of all securities then held under the plan. Each security is also treated as having been reacquired by the taxpayer at that time outside the plan at a cost equal to such proceeds. In addition, each put or call option written and outstanding under the plan is treated as having been closed out and rewritten outside the plan at the price that the taxpayer would pay to close it out on a prescribed stock exchange on January 1, 1986.

For the purposes of these rules, reducing ther plan's indexing base on January 1, 1986 by the cost of closing out put or call options written and then outstanding under the plan produces an inappropriate result. For this reason, paragraph 47.1(28)(a) is amended effective after 1985 so that the indexing base on January 1, 1986 is determined without any reduction for the cost of closing out these options.

Adjusted Cost Base of a Partnership Interest

ITA
53(2)(c)

Clause 8

Section 53 of the Act sets out the rules for determining the adjusted cost base of property for the purpose of the provisions of the Act relating to capital gains. Paragraph 53(2)(c) provides for certain amounts that must be deducted in computing the adjusted cost base to a taxpayer of a partnership interest.

Subparagraph 53(2)(c)(i) provides that the adjusted cost base to a taxpayer of a partnership interest at any particular time must be reduced by the amount of his share of partnership losses flowed out to him before that time. This subparagraph is amended as a consequence of the introduction in section 96 of the provisions relating to limited partnership losses. The amendment excludes such losses from subparagraph (i) and sets out the rule for limited partnership losses separately in new subparagraph 53(2)(c)(i.1). Under this rule a limited partnership loss will reduce the adjusted cost base of a taxpayer's interest in the partnership from which the loss was allocated only to the extent of the amount of the loss deducted in computing his income. The result is that, unlike other partnership losses, a taxpayer's share of a limited partnership loss will reduce the adjusted cost base of his partnership interest only to the extent it is claimed by him as a deduction.

The amendments to paragraph 53(2)(c) are applicable after February 25, 1986.

Other Income

Clause 9

ITA
56(1)(w)

Section 56 of the Act lists certain other sources of income that are required to be included in computing the income of a taxpayer for a taxation year. New paragraph 56(1)(w) is added for the 1986 and subsequent taxation years as a consequence of the introduction of the provisions relating to salary deferral arrangements. Under this new paragraph, a taxpayer is required to include in computing his income for a taxation year amounts received out of or under a salary deferral arrangement in respect of another person to the extent that the amounts received, or amounts that reasonably may be considered to relate to the amounts received, have not been included in computing that other person's income.

Transfer of a Refund of Premiums under a Registered Retirement Savings Plan

Clause 10

ITA
60(1)

Existing paragraph 60(1) of the Act allows a deduction to an individual who receives a refund of premiums out of a registered retirement savings plan (RRSP) and either transfers it into another RRSP or acquires either a life annuity or an annuity with a term equal to 90 minus the age of the individual. A refund of premiums is defined in paragraph 146(1)(h) as an amount paid out of an RRSP of a deceased annuitant prior to its maturity to his spouse or, in certain circumstances, to those of his children or grandchildren who were dependent upon him.

The amendments to paragraph 60(1) extend the permitted investments that qualify for a deduction for a taxpayer who has received a refund of RRSP premiums. The amendments also permit a direct transfer of commutation payments under an RRSP annuity and payments in excess of the minimum amount under a registered retirement income fund (RRIF) to another RRSP or RRIF or to acquire an annuity that qualifies under this provision. The list of permitted investment options which qualify under this provision is expanded to include an investment in any of the following:

- a registered retirement income fund;
- a joint and last survivor annuity with the taxpayer's spouse;
- an annuity with a guaranteed term not exceeding the number of years till the taxpayer, or his spouse, attains 90 years of age; and
- an annuity which provides for full or partial commutation.

These changes, which are effective for the 1986 and subsequent taxation years, are consistent with a number of changes to section 146 relating to reg-

istered retirement savings plans and to section 146.3 relating to registered retirement income funds.

Resource Exploration and Development Expenses

Clause 11

Section 66 of the Act provides various rules with respect to Canadian resource properties.

Subclauses 11(1) to (3)

ITA
66(10.1) to (10.3)

Subsections 66(10.1) to (10.3) of the Act permit a joint exploration corporation to renounce all or any portion of its Canadian exploration expenses, Canadian development expenses and Canadian oil and gas property expenses in favour of a shareholder corporation. The renounced expenses are net of any government assistance received by the joint exploration corporation.

The amendments to paragraphs 66(10.1)(b), (10.2)(b) and (10.3)(b) are consequential on the introduction of the new definition of the term "assistance" in new paragraph 66(15)(a.1). This definition broadens the meaning of "assistance" to include not only governmental assistance but also assistance received from any other person. These amendments are applicable on Royal Assent.

Subclause 11(4)

ITA
66(12.6) to (12.7)

Paragraphs 66.1(6)(a), 66.2(5)(a) and 66.4(5)(a) of the Act respectively define Canadian exploration expense (CEE), Canadian development expense (CDE) and Canadian oil and gas property expense ("COGPE"). Subparagraphs 66.1(6)(a)(v), 66.2(5)(a)(v) and 66.4(5)(a)(iii) relate to what are commonly referred to as the existing flow-through share arrangements. These provisions allow CEE, CDE or COGPE to be deducted by the taxpayer who incurs the expense pursuant to an agreement with a corporation under which the expense was incurred solely as consideration for shares (other than prescribed shares) of the corporation. These subparagraphs will continue to apply with respect to flow-through shares issued pursuant to agreements in writing entered into by a taxpayer and a corporation before 1987.

New subsections 66(12.6) to (12.7) of the Act contain the provisions relating to the new flow-through share mechanism announced in the February 1986 budget. Under these provisions, a principal business corporation (as defined in paragraph 66(15)(h)) that incurs resource expenses may renounce these expenses to a person who acquires "flow-through shares" (as defined in new paragraph 66(15)(d.1)) of the corporation. The amount of resource expenses that are incurred by the corporation and renounced to the person must not exceed the consideration paid by the person for the flow-through shares. Although the corporation and not the person must incur the expenses, the

renounced expenses will be considered to have been incurred by the person on the effective date of the renunciation. Further, on and after the effective date of the renunciation the renounced expenses are considered not to have been incurred by the corporation. There is no restriction on when the shares may be issued. The person's cost of flow-through shares is considered to be nil.

These new provisions are applicable to flow-through shares issued under agreements in writing entered into after February 1986. However, where an agreement is entered into after February 1986 but before 1987, the existing provisions dealing with flow-through shares will apply unless the corporation elects to have these new provisions apply.

ITA 66(12.6)

New subsection 66(12.6) of the Act permits a principal business corporation to renounce Canadian exploration expenses (CEE) that it incurs to a person who acquires the corporation's flow-through shares where the following conditions are met:

- the person must acquire the shares under an agreement entered into between the corporation and the person under which the corporation agrees to incur CEE and to renounce these CEE to the person in respect of the shares;

- the CEE must be incurred by the corporation on or after the day, and within 24 months from the end of the month, the agreement was entered into;

- the renunciation can only be made after the CEE are incurred and after the corporation has received an identification number from Revenue Canada, Taxation in respect of the share issue;

- the renunciation must be made in prescribed form during the period in which the CEE are incurred or within 30 days after the end of the 24-month period;

- the renunciation must declare an effective date which may be earlier than its actual date; however, in such cases, the renounced CEE must have been incurred by the corporation on or before the effective date;

- the expenses must be renounced net of any assistance (as defined in new paragraph 66(15)(a.1)) the corporation receives or may receive in respect of the CEE or in respect of exploration activities to which the expenses relate and net of any prescribed Canadian exploration and development overhead expense (CEDOE) of the corporation (and for this purpose CEDOE will be defined similar to the existing definition of CEDOE contained in section 1206 of the *Income Tax Regulations*);

- the net amount of renounced CEE in respect of a flow-through share cannot exceed the consideration paid for the share less any resource expenses previously renounced in respect of that share; and

- the renounced CEE cannot exceed the corporation's cumulative Canadian exploration expense immediately before the effective date of the renunciation.

This new subsection is applicable with respect to Canadian exploration expenses incurred after February 1986.

ITA 66(12.61)

New subsection 66(12.61) of the act provides that any CEE renounced by a corporation under new subsection 66(12.6) to a person is considered to have been incurred by that person on the effective date of the renunciation and not to have been incurred by the corporation on and after that date. This new subsection is applicable with respect to CEE incurred after February 1986.

ITA 66(12.62)

New subsection 66(12.62) of the Act permits a principal business corporation to renounce Canadian development expenses (CDE) that it incurs to a person who acquires the corporation's flow-through shares where certain conditions are met. These conditions are the same as those that apply to the renunciation of Canadian exploration expenses under new subsection 66(12.6). This new subsection is applicable with respect to CDE incurred after February 1986.

ITA 66(12.63)

New subsection 66(12.63) of the Act provides that any CDE renounced by a corporation under new subsection 66(12.62) to a person is considered to have been incurred by that person on the effective date of the renunciation and not to have been incurred by the corporation on and after that date. This new subsection is applicable with respect to Canadian development expenses incurred after February 1986.

ITA 66(12.64)

New subsection 66(12.64) of the Act permits a principal business corporation to renounce Canadian oil and gas property expenses (COGPE) that it incurs to a person who acquires the corporation's flow-through shares where certain conditions are met. Subject to the exception noted below, these conditions are identical to those applicable to the renunciation of Canadian exploration expenses under new subsection 66(12.6). The exception is that COGPE is renounced by the corporation net of any assistance it receives or may receive but not net of its prescribed Canadian exploration and development overhead expense. This new subsection is applicable with respect to Canadian oil and gas property expenses incurred after February 1986.

ITA 66(12.65)

New subsection 66(12.65) of the Act provides that any COGPE renounced by a corporation under new subsection 66(12.64) to a person is considered to have been incurred by the person on the effective date of the renunciation and not to have been incurred by the corporation on and after that date. This new subsection is applicable with respect to COGPE incurred after February 1986.

ITA 66(12.66)

New subsections 66(12.6), (12.62) and (12.64) of the Act permit a principal business corporation to renounce certain resource expenses to a person who acquires flow-through shares of the corporation. As a general rule, the corpo-

ration may only renounce resource expenses incurred by it on or before the effective date of the renunciation. New subsection 66(12.66) allows certain resource expenses (net of any assistance and of any prescribed Canadian exploration and development overhead expense) that are incurred by the corporation within 60 days after the end of a calendar year to be treated as having been incurred on the last day of the year.

This special rule will apply where the following conditions are met:

- the agreement under which the shares are acquired and the corporation is to incur the expenses must be entered into between the corporation and the person before the end of the calendar year;
- the expenses must be incurred by the corporation within 60 days after the end of the year and, in any case, within the 24-month period from the end of the month in which the agreement was entered into;
- the expenses must be so-called "grass-roots" exploration expenses (within the meaning of subparagraph 66.1(6)(a)(iii)) incurred in respect of a mineral resource other than a bituminous sands deposit, oil sands deposit or oil shale deposit;
- the person must pay the consideration for the share in money before the end of the year;
- the person and the corporation must deal with each other at arm's length throughout the 60-day period;
- the corporation must renounce, in accordance with new subsection 66(12.6) of the Act, the expenses within 90 days after the end of the year and the effective date of the renunciation must be December 31 of the year.

Where these conditions are met, the corporation is considered to have incurred the expenses on December 31 of the year.

This new subsection is applicable with respect to Canadian exploration expenses which are "grass-roots" mining exploration expenses incurred after February 1986.

ITA
66(12.67)

New subsection 66(12.67) of the Act restricts the resource expenses that may be renounced under the new flow-through share rules provided in subsections 66(12.6) to (12.66). A corporation may not renounce resource expenses that are treated as having been incurred by it by virtue of a renunciation of those expenses by another unrelated corporation. The result is that the corporation that issues flow-through shares or a corporation related to it must actually incur the resource expenses that it renounces. This new subsection is applicable with respect to resource expenses incurred after February 1986.

ITA
66(12.68)

New subsection 66(12.68) of the Act requires a corporation that agrees to issue flow-through shares or prepares a selling instrument (as defined in new

paragraph 66(15)(h.1)) in respect of their issue to file an information return in prescribed form together with a copy of the agreement or selling instrument. The Minister of National Revenue will assign an identification number to the return and will notify the corporation of the number. The return must be filed 90 days after this provision receives Royal Assent or on or before the last day of the month following the earlier of the month in which the selling instrument is delivered to an investor and the month in which the agreement is entered into.

This subsection is applicable with respect to expenses incurred after February 1986.

ITA
66(12.69)

New subsection 66(12.69) of the Act provides that a partnership that is treated as having incurred resource expenses in a fiscal period as a consequence of a renunciation under new subsections 66(12.6) to (12.66) must file an information return in prescribed form indicating the amount of the expenses attributed to each of its members for the fiscal period. The form must be filed 90 days after this subsection receives Royal Assent or on or before the last day of the third month following the end of the fiscal period. This subsection is applicable with respect to expenses incurred after February 1986.

ITA
66(12.7)

New subsection 66(12.7) of the Act requires a corporation that renounces resource expenses under new subsections 66(12.6) to (12.66) to file an information return in prescribed form. This information return must be filed 90 days after this subsection receives Royal Assent or on or before the last day of the month following the month in which the renunciation was made. This subsection is applicable with respect to expenses incurred after February 1986.

Subclause 11(5)

ITA
66(14.6)

New subsection 66(14.6) of the Act is consequential on the introduction of a special tax on "carved-out income" imposed under new Part XII.1 of the Act. The objective of the new Part is to prevent the avoidance of tax through the use of carve-out arrangements. In a typical carve-out arrangement, a profitable resource company transfers a temporary interest in a producing resource property to another corporation which has substantial accumulated losses or to a tax-exempt entity. As a result, under the existing provisions of the Act the income from the transferred property is sheltered from tax.
Generally, under new Part XII.1, a taxpayer is required to pay a special tax on his income from a "carved-out property" even if he has losses from other sources or is a tax-exempt entity. To ensure that the carved-out income is not taxed under both the new Part and Part I, new subsection 66(14.6) permits a taxpayer in computing his Part I income to deduct the amount of any carved-out income that is subject to the new Part XII.1 tax.

The amendment is applicable to the 1985 and subsequent taxation years.

Subclause 11(6)

ITA
66(15)(a.1)

New paragraph 66(15)(a.1) of the Act provides a definition of "assistance". Under new subsections 66(12.6), (12.62), (12.64) and (12.66) a corporation may only renounce resource expenses net of any assistance it receives or may receive at any time in respect of those expenses. "Assistance" is defined to include any amount paid or payable at any time by a person or government or any public authority to the corporation.

This subsection is applicable in respect of resource expenses incurred after February 1986.

Subclause 11(7)

ITA
66(15)(d.1)

New paragraph 66(15)(d.1) of the Act provides a definition of "flow-through share" for the purposes of new subsections 66(12.6), (12.62), (12.64), (12.66) and (12.68) and 66.3(3) and (4) and new paragraph 66(15)(h.1). A flow-through share is a share (other than a prescribed share) of the capital stock of a principal business corporation that is issued to a person pursuant to an agreement in writing that is made between the person and the corporation after February 1986 under which the corporation agrees to incur resource expenses and to renounce those expenses to that person. The corporation must agree to incur these resource expenses, in an amount not exceeding the consideration received for the share, in the period commencing on the date of the agreement and ending 24 months from the end of the month in which the agreement was made. The corporation must also agree to renounce these resource expenses in prescribed form within 30 days after the end of that period. A flow-through share is defined to include a right to have the share issued and any interest in the share that the person has under such an agreement.

This new paragraph is applicable with respect to resource expenses incurred after February 1986.

Subclause 11(8)

ITA
66(15)(h.1)

New paragraph 66(15)(h.1) of the Act provides a definition of "selling instrument" for the purpose of new subsection 66(12.68) relating to the required information returns for new flow-through share arrangements. A selling instrument is any document pursuant to which a corporation offers to issue flow-through shares. This paragraph is applicable in respect of resource expenses incurred after February 1986.

Subclause 11(9)

ITA
66(16)

New subsection 66(16) of the Act treats a partnership as a person for the purposes of the new flow-through share provisions and is applicable with respect to fiscal periods ending after February 1986.

Subclauses 11(10) to (14)

These set out the effective dates for the amendments to section 66 of the Act. Subclause 11(12) sets out the effective date of new paragraph 66(15)(d.1) – the definition of "flow-through share". The new flow-through share provisions apply to agreements in writing entered into after February 1986. However, because the existing flow-through share provisions (subparagraphs 66.1(6)(a)(v), 66.2(5)(a)(v) and 66.4(5)(a)(iii)) continue to apply to agreements in writing entered into before 1987, the issuing corporation must elect to have the new provisions apply to an agreement entered into after February 1986 and before 1987. After the end of this year, this election is no longer required because the new flow-through share provisions will apply to agreements entered into after 1986.

Canadian Exploration Expense

Clause 12

Section 66.1 of the Act provides rules relating to the deduction of "Canadian exploration expense".

Subclause 12(1)

ITA
66.1(1)(a)

Subsections 66.1(1) and 59(3.2) of the Act taken together require a taxpayer to include in computing his income for a taxation year any negative balance in his cumulative Canadian exploration expense (CCEE) pool at the end of the year. The amendment to paragraph 66.1(1)(a) is strictly consequential on the extension of investment tax credits to certain Canadian exploration expenses. The effect is to require the amount of investment tax credit claimed by the taxpayer in respect of his qualified Canadian exploration expenditure to be taken into account for the purposes of computing any negative CCEE balance. This amendment is applicable to taxation years ending after November 30, 1985.

Subclauses 12(2) to (5)

ITA
66.1(4) and (5)

Subsections 66.1(4) and (5) of the Act provide the successor corporation rules for the deduction by a corporation of unclaimed Canadian exploration expenses (CEE) incurred by a predecessor. The amendments to these subsections are strictly consequential on the new definition of Canadian exploration expense in subsection 66.1(6) effective for expenses incurred after March 1987. New rules are introduced in subsection 66.1(9) for those expenses that qualify as Canadian development expense (CDE) at the time they were incurred and are subsequently determined to be CEE. Where a successor corporation inherits unclaimed Canadian development expenses of a predecessor and such expenses would have become, pursuant to new subsection 66.1(9), Canadian exploration expense of the predecessor, the successor corporation is required to reduce the balance of its unclaimed cumulative Canadian development expense of the predecessor by an amount determined under sub-

section 66.1(9) and increase its unclaimed cumulative Canadian exploration expense of the predecessor by a similar amount. The amendments to subsections 66.1(4) and (5) ensure that the increase is properly reflected in the cumulative Canadian exploration expense pools.

The closing words of subsections 66.1(4) and (5) are amended, applicable to expenses incurred after March 1987, to reflect the addition of new subparagraphs 66.1(4)(a)(ii) and (5)(a)(ii) to the Act.

Subclause 12(6)

ITA
66.1(6)(a)

Paragraph 66.1(6)(a) defines oil, gas and mining expenses that qualify for treatment as Canadian exploration expense eligible for a 100-per-cent write-off rate. The amendment to the preamble to the definition removes the reference to "outlay" since only expenses incurred may qualify as Canadian exploration expenses. This amendment is effective on Royal Assent.

Subclause 12(7)

ITA
66.1(6)(a)(ii)

Subparagraph 66.1(6)(a)(ii) describes the drilling and other related expenses incurred before 1986 in respect of a well that qualify as Canadian exploration expenses. The amendment to this definition extends the expiry date of the existing definition of CEE to March 31, 1987. Any expenses incurred after that date will be dealt with under the new rules as set out in subparagraphs 66.1(6)(a)(ii.1) and (ii.2) described below.

Subclause 12(8)

ITA
66.1(6)(a)(ii.1)
and (ii.2)

Paragraph 66.1(6)(a) of the Act provides the definition of "Canadian exploration expense" (CEE). Subparagraphs (ii.1) and (ii.2) thereof describe the oil and gas drilling expenses incurred after 1985 that are included in that definition. The changes to this definition as announced by the Minister of Finance on December 31, 1985 and March 27, 1986 are intended to clarify the distinction between exploration and development expenses.
The amendment to subparagraph (ii.1) applies to expenses incurred after March 31, 1987 and includes in the CEE definition certain expenses incurred in a taxation year in respect of an oil or gas well

- that resulted in a discovery of a natural accumulation of petroleum or natural gas before six months after the year.
- that was abandoned without having ever produced (other than for specified purposes) in the year or within six months after the end of the year,
- that has not produced (except for specified purposes) during the 24-month period after drilling is completed and that period ends in the year, or

- in respect of which a prescribed certificate is filed with the Minister of National Revenue within 60 days after the calendar year in which drilling commenced.

In order to be eligible for the prescribed certificate referred to above, the taxpayer will be required to demonstrate that the well will not produce within a 24-month period following the completion of the drilling and that the eligible costs in respect of the well will exceed $5 million.

In cases where the 24-month period is relevant, an expense of the taxpayer will be treated as a Canadian development expense (CDE) in the year in which it is incurred. Where the necessary conditions in new subsection 66.1(9) are satisfied, any such CDE will be treated as a CEE in the taxation year in which the 24-month period ends. See the commentary on that provision. The result of these rules will be to generally deny CEE treatment to any expense incurred in respect of a producing well unless production commences later than 24 months after drilling is completed.

Subparagraph (ii.2) is amended, with application after 1985, as a consequence of the introduction of new subsection 66.1(9) and reference should be made to the commentary on that provision.

The application of new paragraphs 66.1(6)(a)(ii.1) and (ii.2) and subsection 66.1(9) is illustrated in the following example:

> Assume that Opco has a December year end. On January 1, 1988, it commences the drilling of a gas well and incurs $10,000 of qualifying expenses in repect of the well before drilling is completed on March 31, 1988. In 1990 Opco incurs additional qualifying expenses of $5,000 for the completion of the well.
>
> (A) If the well resulted in the discovery of an accumulation before July 1, 1989 the tax consequences would be:
>
> - $10,000 will be treated as CEE in 1988 under clause 66.1(6)(a)(ii.1)(A); and
> - $5,000 will be treated as CEE in 1990 under clause 66.1(6)(a)(ii.1)(A) since these expenses relate to a discovery that occurred in a preceding taxation year.
>
> (B) If the well is abandoned on June 29, 1989 without ever having produced (except for specified purposes) the tax consequences would be:
>
> - $10,000 will be treated as CEE for the 1988 taxation year under clause 66.1(6)(a)(ii.1)(B) since the well was abandoned within six months following the end of that year; and
> - any expenses incurred in the 1988 or 1989 taxation year in completing the well would qualify as CEE in the year incurred.

(C) If the well does not produce within a 24-month period the tax consequences would be:

- $10,000 will be treated as CDE in 1988; however, it will be reclassified as CEE in 1990 pursuant to new subparagraph 66.1(6)(a)(ii.2) and subsection 66.1(9) as the well did not produce within the 24-month period; and
- if $5,000 was incurred before March 31, 1990, it will be treated as CEE pursuant to clause 66.1(6)(ii.1)(C); expenses incurred after that date will be treated as CDE.

Subclause 12(9)

ITA
66.1(6)(a)(v)

Subparagraph 66.1(6)(a)(v) of the Act accommodates the existing flow-through share mechanism for Canadian exploration expenses. This amendment provides that this subparagraph applies only in respect of agreements in writing entered into before 1987. After 1986, the new flow-through share mechanism described in the commentary on the amendments to section 66 replaces the existing mechanism.

Subclause 12(10)

ITA
66.1(6)(a)

The amendment to the closing words of paragraph 66.1(6)(a) of the Act, effective on Royal Assent, is consequential on the introduction of the definition of "assistance" in new paragraph 66(15)(a.1).

Subclause 12(11)

ITA
66.1(6)(b)(ix)

Paragraph 66.1(6)(b) of the Act provides the definition of "cumulative Canadian exploration expense" (CCEE). Subparagraph (ix) thereof reduces the CCEE pool of a taxpayer by any government assistance received by him in respect of any Canadian exploration expense included in the pool. Under new subsection 66.1(9) a taxpayer may reclassify his Canadian development expense in a preceding taxation year as Canadian exploration expense. As a general rule, these expenses are reclassified after taking into account any related government or other assistance (within the broader definition of "assistance" contained in new paragraph 66(15)(a.1). The amendment to this subparagraph ensures that the CCEE pool of the taxpayer is not also reduced by the related government or other assistance that has already reduced his CCDE pool.

This amendment is applicable with respect to expenses incurred after Royal Assent except that a special rule applies with respect to expenses incurred after Royal Assent but before April 1987. In this case, subparagraph (ix) is amended to incorporate the broader definition of assistance but to exclude any reference to new subsection 66.1(9).

Subclause 12(12)

ITA
66.1(6)(b)(xi)

Paragraph 66.1(6)(b) of the Act provides the definition of "cumulative Canadian exploration expense" (CCEE). New subparagraph (xi) is added to reduce a taxpayer's CCEE pool by any investment tax credit claimed by him in respect of his qualified Canadian exploration expenditure. This provision is applicable after November 30, 1985.

Subclause 12(13)

ITA
66.1(6)(c) and (d)

New paragraphs 66.1(6)(c) and (d) add two new definitions that relate to the reclassification of a taxpayer's "Canadian development expense" (CDE) to "Canadian Exploration expense" (CEE) under new subsection 66.1(9). The term "restricted expense" is defined in new paragraph (c). The expenses so defined do not qualify for reclassification under new subsection 66.1(9) as CEE. For example, CDE incurred before April 1987 is a restricted expense that does not qualify. Similarly, a joint exploration corporation that renounces CDE, a principal business corporation that renounces CDE under a flow-through share arrangement or a taxpayer who sells CDE under a unitization agreement will not be able to reclassify this CDE under new subsection 66.1(9). However, CDE will qualify for reclassification under that provision in the hands of the recipient on the renunciation or acquisition. The definition provides that CDE will not qualify for reclassification under new subsection 66.1(9) if it has been reclassified under that provision by the taxpayer or any other taxpayer. The definition also provides that a corporation that incurs CDE before its change of control cannot reclassify such CDE under subsection 66.1(9). However, this CDE may be eligible for reclassification under the successor rule provisions set out in new subsections 66.1(10) and (11), as discussed in more detail in the commentary on those provisions.

The term "specified purposes" is defined in new paragraph 66.1(6)(d). Under this definition certain types of production are treated as non-commercial in nature and, as a result, do not prevent certain drilling or other related expenses in respect of a well from being reclassified as CEE under paragraph 66.1(6)(a) on the basis of the well being a producing well. For example, the testing of a well, wellhead or related equipment, in accordance with generally accepted engineering practices, is treated as a non-commercial activity. In addition, gas production that is burned to protect the environment is also treated as non-commercial production. Subparagraph (iii) of the definition permits other purposes to be prescribed as specified purposes. It is the intention to prescribe production from a well drilled under agreements with native persons where the production is used for certain purposes by those native persons on native lands.

Subclause 12(14)

ITA
66.1(8)

Where a taxpayer incurs Canadian exploration expenses in a taxation year in respect of a flow-through share, the taxpayer may deduct the expenses in

computing his income for the year under section 66.1 of the Act. New subsection 66.1(8) provides that where a taxpayer incurs mining exploration expenses in respect of such a share within 60 days after the end of a calendar year, the taxpayer can treat the expenses as having been incurred by him before the end of the year. These mining exploration expenses are commonly referred to as "grass-roots exploration expenses" and are incurred in respect of a mineral resource other than a bituminous sands deposit, oil sands deposit or oil shale deposit. These expenses qualify for this special treatment under new subsection 66.1(8) if the agreement under which they were incurred was entered into by the taxpayer and an arm's length corporation, and the mining exploration funds were advanced by the taxpayer, before the end of the year. This amendment is applicable with respect to mining expenses incurred after December 31, 1985.

ITA
66.1(9) to (11)

New subsection 66.1(9) permits a taxpayer's Canadian development expense (CDE) described in clause 66.2(5)(a)(i)(B) and incurred in a taxation year in respect of an oil or gas well to be reclassified as Canadian exploration expense in a subsequent year. It also permits the reclassification of the taxpayer's CDE that he is considered to have incurred before its reclassification under subsections 66(10.2) and (12.3) and new subsection (12.63).

This new subsection provides for this reclassification in a taxation year in which

- the well results in the discovery of a natural accumulation of petroleum or natural gas;
- the well is abandoned and has never produced, except for specified purposes; or
- the 24-month period after drilling is completed ends and the well has never produced, except for specified purposes.

Where any of these conditions is met, the taxpayer may reclassify as CEE any CDE described in clause 66.2(5)(a)(i)(B) (other than a restricted expense) that was incurred by him in a preceding taxation year (and after March 31, 1987) or that was considered to have been incurred by him in the year or a preceding taxation year (and after March 31, 1987) under subsections 66(10.2) and (12.3) and new subsection (12.63).

This new subsection is applicable to expenses incurred after March 1987.

New subsections 66.1(10) and (11) of the Act provide special rules relating to the reclassification of a taxpayer's CDE under new subsection (9) in situaitons involving the successor rules. These new subsections permit a successor corporation to reclassify unclaimed CDE of a predecessor incurred after March 1987 if the predecessor would have been entitled to do so under subsection (9).

Subclauses 12(15) to (19)

These set out the effective dates for the amendments to section 66.1 of the Act.

Canadian Development Expenses

Clause 13

Section 66.2 of the Act provides rules relating to the deduction of a Canadian development expense.

Subclauses 13(1) to (4)

ITA
66.2(3) and 66.2(4)

Subsections 66.2(3) and (4) of the Act provide the successor corporation rules for the deduction by a corporation of unclaimed Canadian development expenses (CDE) incurred by a predecessor. The amendments to these subsections are consequential on the introduction of new subsections 66.1(10) and (11) which permit a reclassification of certain unclaimed Canadian development expenses of a predecessor incurred after March 1987 to Canadian exploration expenses.

Where a successor corporation inherits unclaimed CDE of a predecessor and such expenses would have become CEE of the predecessor under new subsection 66.1(9), new subsections 66.1(10) and (11) permit the successor corporation to reduce the balance of its unclaimed cumulative Canadian development expense of the predecessor by an amount determined under subsection 66.1(9) and increase the unclaimed cumulative Canadian exploration expense of the predecessor by a similar amount. The amendments to subsections 66.2(3) and (4) ensure that the reduction is properly reflected in the cumulative Canadian develpment expense pools.

The closing words of subsections 66.2(3) and (4) are amended, applicable to expenses incurred after March 1987, to reflect the addition of new clauses 66.2(3)(a)(i)(B) and (4)(a)(i)(B) to the Act.

Subclauses 13(5) to (8)

ITA
66.2(5)(a)

Paragraph 66.2(5)(a) of the Act provides the definition of "Canadian development expense" (CDE). This paragraph is amended to delete the reference to "outlay" and substitute the word "cost"in the preamble of the definition. The reference to outlays is inappropriate since only expenses and certain costs incurred may qualify as CDE. This amendment is applicable on Royal Assent.

New subsection 66.1(9) permits a taxpayer's CDE to be reclassified as Canadian exploration expense (CEE). Any CDE of a taxpayer that is reclassified as CEE under new subsection 66.1(9) must be removed from the tax-

payer's cumulative Canadian development expense pool. The amendment to clause 66.2(5)(a)(i)(B) ensures that any CDE that is reclassified is treated as an addition to the cumulative Canadian development expense notwithstanding such reclassification. The result is that this reclassified CDE is not also removed from the taxpayer's CCDE under clause (i)(B) which provides that an expense is not CDE to the extent that it is CEE in the year it was incurred. This amendment is applicable to expenses incurred after March 1987.

Subparagraph 66.2(5)(a)(v) of the Act accommodates the existing flow-through share mechanism for Canadian development expenses. This amendment provides that this subparagraph applies only in respect of agreements in writing entered into before 1987. After 1986, the new flow-through share mechanism described in the commentary on the amendments to section 66 replaces the existing mechanism.

The amendment to the closing words of paragraph 66.2(5)(a) of the Act, effective on Royal Assent, is consequential on the introduction of the definition of "assistance" in new paragraph 66(15)(a.1).

Subclause 13(9)

ITA
66.2(6)(b)(vii)
and (vii.1)

Paragraph 66.2(5)(b) of the Act provides the definition of "cumulative Canadian development expense" (CCDE). Subparagraph (vii) thereof reduces a taxpayer's CCDE to the extent that his CDE is reclassified as CEE under clause 66.1(6)(a)(ii)(B). The amendment to this subparagraph eliminates the reference to clause 66.1(6)(a)(ii.1)(B) which has been repealed.

New subparagraph (vii.1) is consequential on the introduction of new subparagraph 66.1(6)(a)(ii.2) and subsection 66.1(9) and ensures that any CDE amounts that are reclassified as CEE are removed from CCDE.

These amendments are applicable to expenses incurred after March 1987.

Subclause 13(10)

ITA
66.2(5)(b)(xi)

Subparagraph 66.2(5)(b)(xi) of the Act ensures that any government assistance received or receivable by a taxpayer in respect of a Canadian development expense of the taxpayer reduces the taxpayer's cumulative Canadian development expense. The amendment to this subparagraph is consequential in part on the introduction of new subsection 66.1(9) relating to the reclassification of CDE as CEE and in part on the new definition of "assistance" in paragraph 66(15)(a.1). The meaning of assistance has been broadened to include assistance received from any person rather than being restricted to

government assistance. The bracketed words in this subparagraph ensure that any assistance received by a taxpayer in respect of a Canadian development expense will remain as a deduction in computing the cumulative Canadian development expense of the taxpayer notwithstanding the reclassification of this expense as Canadian exploration expense.

This amendment is applicable on Royal Assent except that a special rule applies with respect to expenses incurred after Royal Assent but before April 1987. In this case, subparagraph (xi) is amended to incorporate the broader definition of assistance but to exclude any reference to new subsection 66.1(9).

Subclauses 13(1) and (12)

These set out the effective dates for the amendments to section 66.2.

Resource Flow-Through Shares

Clause 14

ITA
66.3(3)
and (4)

Section 66.3 of the Act provides rules relating to flow-through shares. Subsection 66.3(1) of the Act provides that a taxpayer's cost of a flow-through share is nil. New subsection 66.3(3) provides that a person's cost of a flow-through share under the new provisions for such shares contained in new subsections 66(12.6) to (12.7) is also nil. This new subsection is applicable after February 1986 when the new rules relating to flow-through shares take effect.

Subsection 66.3(2) of the Act provides rules for computing the paid-up capital of a corporation that issues flow-through shares under the existing provisions of the Act. New subsection 66.3(4) provides similar rules for computing the paid-up capital of a corporation that issues flow-through shares after February 1986 under the new provisions for such shares contained in new subsections 66(12.6) to (12.7). New paragraph (a) requires a reduction in a corporation's paid-up capital to the extent the increase in such capital as a consequence of a flow-through share issue exceeds the excess of the consideration received for the shares over 50 per cent of the related resource expenses renounced to the persons who acquired the shares.

New paragraph (b) requires an addition to a corporation's paid-up capital in circumstances where new paragraph (a) has required a reduction and subsections 84(3), (4) or (4.1) subsequently apply to treat a dividend as having been paid by the corporation on shares of the same class as the flow-through shares. The additions for a class of shares under this new paragraph may not exceed the reductions for that class under new paragraph (a).

Canadian Oil and Gas Property Expenses

Clause 15

Section 66.4 of the Act provides rules relating to the deduction of Canadian oil and gas property expense.

Subclause 15(1)

ITA 66.4(5)(a)

Paragraph 66.4(5)(a) of the Act provides the definition of "Canadian oil and gas property expense" (COGPE). This paragraph is amended to delete the reference to "outlay" and substitute "cost" in the preamble of the definition. The reference to outlays is inappropriate since only expenses and costs incurred may qualify as COGPE. This amendment is applicable on Royal Assent.

Subclauses 15(2) and (3)

ITA 66.4(5)(a)

Subparagraph 66.4(5)(a)(iii) of the Act accommodates the existing flow-through share mechanism for Canadian oil and gas property expenses. This amendment provides that this subparagraph applies only in respect of agreements in writing entered into before 1987. After 1986, the new flow-through share mechanism described in the commentary on the amendments to section 66 replaces the existing mechanism.

The amendment to the closing words of paragraph 66.4(5)(a) of the Act, effective on Royal Assent, is consequential on the introduction of the definition of "assistance" in new paragraph 66(15)(a.1).

Subclause 15(4)

ITA 66.4(5)(b)(viii)

Paragraph 66.4(5)(b) of the Act provides the definition of "cumulative Canadian oil and gas property expense". Subparagraph (viii) thereof reduces this account of a taxpayer by any government assistance received by him. The amendment to this subparagraph, effective on Royal Assent, is consequential on the introduction of the definition of "assistance" in new paragraph 66(15)(a.1).

Successor Corporation Rules

Clause 16

ITA 66.6

The existing successor rules of the Act permit a taxpayer to transfer certain unused resource expenses on a disposition of all or substantially all of his Canadian resource properties to a corporation. These expenses may be deducted by the acquiring corporation to the extent of its income from the transferred properties. These rules are appropriate where a resource business

is transferred between taxable persons. However, tax-exempt persons cannot use their resource expenses because of their non-taxable status. The ability of exempt persons to transfer unused resource expenses produces undesirable tax results, particularly in arrangements involving so-called "carve-outs".

New subsections 66.6(1) and (2) deny the availability of the successor rules where a corporation acquires Canadian resource properties from a tax-exempt person. An exception to this restriction is made where the transferor is a Crown corporation that is a principal business corporation. In this case the successor rules relating to unused resource expenses, other than unused Canadian oil and gas property expense, will apply.

New section 66.6 is applicable for transfers occurring after July 19, 1985 except where the property was acquired after that date but before 1987 pursuant to an agreement in writing to do so made by the acquiring corporation before July 20, 1985.

Attribution Rules

ITA
74.5(12)

Clause 17

Sections 74.1 to 74.5 of the Act contain comprehensive rules (generally referred to as the "attribution rules") designed to prevent a taxpayer from splitting his or her income among family members and thereby reducing the total amount of tax payable. These rules ordinarily apply where property is transferred after May 22, 1985 by an individual to or for the benefit of his spouse or a person who was under 18 years of age. New subsection 74.5(12) provides the exemptions from these rules that were previously provided under subsection 74(6) of the Act before its repeal in Bill C-84. These exemptions are restored by this amendment. Thus the attribution rules will not apply with respect to a premium paid by a taxpayer to a spousal registered retirement savings plan (RRSP). Nor will the attribution rules apply to a salary, interest or other payment by the taxpayer to his spouse or a person under 18 years of age in circumstances where the amount paid is deductible in computing the taxpayer's income and is included in computing the recipient's income. This subsection is applicable to RRSP premiums and amounts paid after May 22, 1985.

Unpaid Remuneration

ITA
78(3) to (6)

Clause 18

Section 78 of the Act provides rules which effectively limit the deductibility of certain expenses, including remuneration, that are not paid by a taxpayer within a specified period. The amendments to this section restrict the deductibility of remuneration in a taxpayer's taxation year that is not paid within 180 days following the end of that year.

New subsection 78(3) picks up the special rule previously reflected in existing subsection 78(6) of the Act which permits a taxpayer to avoid the application of the rules by filing a prescribed agreement and paying a

penalty. New subsection 78(3) is restricted to expenses in a non-arm's length transaction and requires a taxpayer to include in income 25 per cent of these unpaid expenses where a prescribed agreement is filed after the time provided by subsection 78(1). This amendment is effective for taxation years commencing after February 25, 1986.

Existing subsection 78(3) of the Act deals with accrued but unpaid remuneration. It provides that the remuneration of an employee that is unpaid at the end of the first taxation year following the year in which the expense was incurred and deducted by the employer must be added back to the employer's income for the second taxation year. Alternatively, where the employer and the employee file an agreement with the Minister of National Revenue, the unpaid amount will be considered to have been paid by the employer and received by the employee on the first day of the second taxation year. These rules permit up to a two-year deferral of tax.

The new rules relating to unpaid remuneration are set out in subsection 78(4) and reduce this opportunity for deferral. Under the new rules, an employer will be entitled to deduct the amount of his expenses in respect of salary, wages or other remuneration, other than reasonable vacation or holiday pay, in the taxation year in which the expense was incurred only if the amount is paid within 180 days from the end of that year. Where the payment is not made within this period, the employer will be allowed to deduct the salary and wages expense in his subsequent taxation year in which payment is made. New subsection 78(4) is applicable to taxation years commencing after February 25, 1986.

Subsection 78(5) of the Act gives priority to the rules in new subsection 78(4) relating to unpaid remuneration in those circumstances where the unpaid remuneration is payable to a non-arm's length person and would, but for the priority, also fall within the scope of subsection 78(1). New subsection 78(5) is applicable to taxation years commencing after February 25, 1986.

Debtor's Gain on Settlement of Debts

Clause 19

ITA
80(1)(a)

Section 80 of the Act sets out the rules that apply where a debt owing by a taxpayer is settled or extinguished for less than its principal amount. In most circumstances the resulting gain is not immediately taxable to the debtor taxpayer but, rather, reduces in turn the amount of his deductible loss carryovers from preceding taxation years, the capital cost of his depreciable property and the adjusted cost base of any other capital property.

The amendment to paragraph 80(1)(a) is consequential on the introduction of the new rules relating to limited partnership losses and the new carryover in respect of such losses in paragraph 111(1)(e). As a result of this amendment, the gain to which the rules in section 80 apply in a year reduces, in order, the debtor's non-capital losses, farm losses, net capital losses, restricted farm losses and limited partnership losses for preceding taxation years. This amendment is applicable after February 25, 1986.

Taxable Dividends

Clause 20

ITA
82(1)(b)

Where an individual receives taxable dividends from a taxable Canadian corporation, existing subsection 82(1) of the Act requires him to include in his income one and one-half times the amount of the actual dividends received. The individual is then subject to tax on this grossed-up amount and is entitled to claim a dividend tax credit under section 121. This amendment, effective for dividends received after 1986, provides that the amount which an individual will be required to include in his income will be one and one-third times the actual amount of such dividends received.

Amalgamations

Clause 21

Section 87 of the Act deals with the tax treatment of the amalgamation of two or more taxable Canadian corporations.

Subclause 21(1)

ITA
87(2)(g.1)

New paragraph 87(2)(g.1) has been added to the Act to correct a technical deficiency. This new paragraph provides that, for the purposes of the rules relating to the special reserve for banks under section 26 of the Act, a new corporation formed as a result of an amalgamation shall be treated as a continuation of each predecessor corporation. The amendment, which is applicable for amalgamations after 1979, extends the same treatment for bank reserves as is allowed for other reserves on an amalgamation.

Subclause 21(2)

ITA
87(2)(j.3)

The amendment to paragraph 87(2)(j.3) of the Act is consequential on the introduction of the new provisions relating to salary deferral arrangements. The amendment treats an amalgamated corporation as a continuation of its predecessors for the purpose of these new rules. This change is applicable to amalgamations occuring after February 25, 1986.

Subclause 21(3)

ITA
87(2.1)

Subsection 87(2.1) of the Act permits an amalgamated corporation to deduct the unclaimed non-capital and net capital losses of its predecessor corporations. This subsection is amended as a consequence of the introduction of the new provisions relating to limited partnership losses. This amendment treats the amalgamated corporation as a continuation of its predecessor corpora-

tions for the purpose of claiming the unused limited partnership losses of such predecessors. The amendments to subsection 87(2.1) are applicable after February 25, 1986.

Subclauses 21(4) to (6)

These set out the effective dates for the amendments to section 87 of the Act.

Winding-up of a Corporation

Clause 22

ITA
88(1.1)

Subsection 88(1.1) of the Act permits a parent corporation to use the non-capital losses of a subsidiary corporation which has been wound up where the parent owned at least 90 per cent of the subsidiary's issued shares. This provision is amended as a consequence of the introduction of the new provisions relating to limited partnership losses. The amendment is necessary to permit a parent corporation to use the limited partnership losses of a subsidiary following a winding-up. The amendments to subsection 88(1.1) are applicable after February 25, 1986.

Limited Partnership Losses

Clause 23

ITA
96(2.1) to (2.5)

Section 96 of the Act sets out the general rules relating to partnerships and their members. New subsections 96(2.1) to (2.5) implement the February 1986 budget proposals concerning the deductibility of losses flowed out to limited partners of a partnership.

New subsection 96(2.1) of the Act provides that the losses of a partnership allocated to a limited partner in his taxation year will be deductible by the partner only to the extent of the partner's at-risk amount as at the end of the fiscal period of the partnership ending in that year. Where investment tax credits have also been allocated to the limited partner, these credits will reduce the partner's remaining at-risk amount for the purpose of determining the amount of the losses that are deductible by the partner. The new provisions apply to losses of the partnership from business or property. No restriction is applied, however, in respect of resource deductions, capital losses or farm losses (although the farm losses may be restricted under existing section 31 of the Act). These other losses and deductions will, however, reduce the at-risk amount of the limited partner for the purposes of determining the extent to which those losses subject to the new rules may be deducted. Losses rendered non-deductible by the new rules are designated as limited partnership losses and as such are eligible under new paragraph 111(1)(e) for an indefinite carry-forward against future income from the partnership which generated the losses. As well, limited partnership losses may be deducted in future years where the taxpayer's at-risk amount in respect of the partnership increases – for example, by way of an increased investment in the partnership.

The assessing practice of Revenue Canada with respect to limited partnerships, as that practice was followed prior to February 26, 1986, will continue to apply to those taxpayers entitled to deductions or credits that are not restricted by these new provisions.

New subsection 96(2.2) of the Act defines the at-risk amount of a limited partner at any particular time.

This at-risk amount is calculated as follows:

- the partner's adjusted cost base of his partnership interest,
- plus his share of the current year's income from the partnership,
- less all amounts owing by the partner to the partnership and any amount or benefit to which the partner is entitled, where the amount or benefit is intended to protect him from the loss of his investment.

For the purpose of the reduction of the at-risk amount in respect of amounts owing to the partnership, loans between persons dealing not at arm's length with the partner or the partnership are taken into account.

Thus, for example, where a general partner of a partnership has lent money to a limited partner in order to fund that limited partner's contribution to the partnership, the amount of that loan will reduce the limited partner's at-risk amount. Similarly, where an amount or benefit is made available to a person with whom the limited partner does not deal at arm's length, a reduction of the limited partner's at-risk amount will be required. A limited partner's at-risk amount is not reduced by protection from a loss on his investment that takes the form of

- normal liability insurance protection,
- agreements to purchase the partnership interest at any time at its fair market value at that time, or
- a buy-sell agreement relating to the partnership interest that applies in the event of the death of the owner thereof.

As a general rule, revenue guarantees in respect of the gross revenues of a partnership will not be considered to be an amount or benefit protecting a partner from loss and will therefore not reduce his at-risk amount. Nevertheless, where a revenue guarantee directly or by necessary implication ensures the partner of the return of a portion of his investment, an at-risk reduction is required. A specific provision excludes from this rule prescribed revenue guarantees in respect of certified film productions, in recognition of other rules in the *Income Tax Regulations* applicable to such guarantees. Where a limited partner has a right to exchange his partnership interest for some other property, he is considered to be entitled to an amount or benefit protecting him from loss to the extent of the fair market value of the other property at the time at which the at-risk amount is being computed.

New subsection 96(2.3) of the Act deals with the computation of the at-risk amount where a limited partnership interest is acquired by a second or subsequent owner. The subsection provides special rule for the determination of the amount to be used as a limited partner's cost of his partnership interest where the limited partner is not the first person to acquire the interest. In such circumstances, the cost of the interest, for the purposes only of the at-risk rules, is the lesser of its actual cost and the adjusted cost base of the taxpayer from whom it was acquired.

New subsection 96(2.4) of the Act provides an extended definition of a limited partner which is relevant for the purposes of restrictions on partnership investment tax credits and losses. A partner is considered to be a limited partner of a partnership at a particular time where, at that time or within three years thereafter,

- the partner's exposure in respect of his partnership interest is limited by statutory authority,

- the partner's exposure in respect of his partnership interest is limited by contract (other than a normal contract of insurance),

- the existence of the partner, such as a corporation formed only to hold the partnership interest, provides limited liability, or

- there is an agreement to wind up the partnership or to dispose of his partnership interest and one of the main reasons for the agreement may reasonably be considered to be to circumvent the definition of limited partner.

In the third case involving "shell" corporations or, possibly, trusts, the partner will not be considered to be a limited partner where one of the reasons for its existence is to permit those persons who have invested in the partner to carry on their ordinary business in the most effective manner. A person is not considered to be a limited partner in respect of an "exempt interest" as that expression is defined in new subsection 96(2.5).

New subsection 96(2.5) of the Act provides grandfather protection in respect of interests in a partnership which was existing on February 25, 1986. If his partnership interest is an exempt interest, a person who would otherwise be considered to be a limited partner will not be subject to the new rules. In general, an exempt interest is defined as at a particular time and means an interest in a partnership that was carrying on business on a regular and continuous basis on February 25, 1986 and continuously until that particular time. Nevertheless, a partnership interest can lose exempt status where, after February 25, 1986, there has been a substantial contribution of capital to the partnership or substantial partnership borrowings. New subsection 96(2.5) describes three circumstances where such contributions or borrowings will not be considered substantial. These circumstances are:

- where the funds are required to fulfill contractual obligations entered into by the partnership before February 26, 1986,

- where the funds are raised pursuant to a prospectus, preliminary prospectus or registration statement filed with the appropriate securities authority before February 26, 1986, or

- where the use of the funds was for the day-to-day operation or maintenance of the business as it existed on February 25, 1986.

For the purposes of these rules a partnership, in respect of which funds have been raised pursuant to a prospectus filed with an appropriate authority before February 26, 1986, will be considered to have been carrying on business on a regular and continuous basis on February 25, 1986 and continuously thereafter until the closing date stipulated in the prospectus or January 1, 1987, whichever is the earlier date.

Funds will be considered to have been **required** to fulfill a contractual obligation to make an expenditure entered into before February 26, 1986 if the obligation is unconditional, or if a condition is applicable, the condition does not relate to any proposed or actual change in the tax consequences of the expenditure under the *Income Tax Act*. Accordingly, for the purposes of the definition of "exempt interest" an obligation conditional upon entitlement to transitional relief or grandfather protection from these budget proposals would not be considered to have been **required** to have been made.

Partnership Dissolutions

Clause 24

Subclauses 24(1) and (2)

ITA
98(3)(b)(ii)
and (d)

Subsection 98(3) of the Act is an elective provision permitting property of a Canadian partnership which has ceased to exist to be distributed to its members for proceeds to the partnership and at a cost to the members equal to the cost amount of the property to the partnership. This special rollover applies where all of the property of the partnership has been distributed to the members of the partnership and each member receives an undivided interest in each partnership property equal to his undivided interest in each other property distributed.

This provision allows a special increase or "bump-up" in the tax value of the distributed partnership property in those circumstances where the adjusted cost base of a member's partnership interest exceeds the amount of any money and the cost amount to the partnership of the property which he has received upon the dissolution. The rule which provides for the special increases in value for non-depreciable capital property is contained in paragraph 98(3)(c) and is not affected by these amendments. The provision which governs the increase for property other than non-depreciable capital

property is contained in paragraph 98(3)(d) and is being repealed. The amendment to subparagraph 98(3)(b)(ii) is consequential, simply deleting the reference therein to repealed paragraph 98(3)(d).

Subclauses 24(3) and (4)

ITA
98(5)(b)(ii)
and (d)

Subsection 98(5) of the Act is a non-elective provision which applies only in situations where a Canadian partnership has ceased to exist and one member continues to carry on the business of the partnership as a sole proprietorship.

This subsection provides that the partnership shall be deemed to have disposed of its property at its cost amount and that the remaining member will be deemed to have acquired the property at the same amount. Where the adjusted cost base of the member's partnership interest, including the interests acquired from other members of the partnership, exceeds the amount of any money and the cost amount to the partnership of the property received by him upon the dissolution, the member may designate this excess to be added to the cost base of one or more particular properties. The rule which provides for this addition or "bump-up" for non-depreciable capital property is contained in paragraph 98(5)(c) and is not affected by these amendments. The provision which governs the addition in respect of property other than non-depreciable capital property is contained in paragraph 98(5)(d) and is repealed. The amendment to subparagraph 98(5)(b)(ii) is consequential, simply deleting the reference therein to repealed paragraph 98(5)(d).

Subclause 24(5)

This sets out the effective date for the amendments to subsections 98(3) and (5) of the Act. Paragraph (a) provides that the amendments will apply to property acquired by a partnership after December 4, 1985, except where a written agreement to acquire the property has been entered into before that date. Under paragraph (b), the amendments will also apply in those circumstances where the partnership property is received by the partner in satisfaction of a partnership interest acquired after December 4, 1985, other than one acquired pursuant to a written agreement entered into on or before that date or where the interest was acquired in a non-arm's length transaction and has not been transferred in an arm's length transaction after December 4, 1985. For the purpose of determining whether a partnership interest has been acquired from a person with whom the member was not dealing at arm's length, paragraph 251(5)(b) of the Act is to be ignored. Finally, these amendments will apply where the partnership interest was owned by a corporation at a time after December 4, 1985 when control of the corporation was acquired.

Definitions for Partnership Rules

Clause 25

ITA
102

Section 102 provides definitions for the purposes of the rules in subdivision j of the Act relating to partnerships and their members. This section is

amended to provide that, for the purposes of those rules, a reference to a taxpayer or a person who is a member of a particular partnership shall include a reference to another partnership that is a member of the particular partnership. This amendment clarifies that the rules relating to partnerships are applicable to a member of a partnership which is itself a partnership. The amendment to section 102 is applicable after February 25, 1986.

Rules Relating to the Taxation of Trusts

Clause 26

Section 104 of the Act deals with the taxation of trusts.

Subclause 26(1)

ITA 104(7.1) and (7.2)

New subsections 104(7.1) and (7.2) of the Act are anti-avoidance provisions that seek to prevent the use of trusts to allocate income and capital of the trust to different beneficiaries and thereby permit beneficiaries to receive a predetermined amount as a return of capital or a capital gain. New subsection 104(7.1) applies to any trust where it is reasonable to consider that one of the main purposes for the creation of an interest in the trust is to give a beneficiary a percentage interest in the property of the trust that is greater than his percentage interest in its income. The provision does not apply to a testamentary trust or any inter-vivos trust in which no beneficial interest was acquired for consideration payable to the trust or payable to any person who has made a contribution to the trust. Where the provision applies, the trust is denied a deduction in computing its income for a taxation year for amounts that were payable by it in the year to any beneficiary or were included in computing a beneficiary's income by virtue of subsection 105(2). This new subsection is applicable to the 1986 and subsequent taxation years of a trust, other than a trust created before November 27, 1985 that has not, except as described below, issued any beneficial interest therein after 5:00 p.m. EST on November 26, 1985. An exception is where the interest is issued on account of a trust distribution of income under trust terms in effect on November 26, 1985 – the date on which the new rules were announced.

New subsection 104(7.2) of the Act ensures that new subsection 104(7.1) cannot be avoided through the use of options. Where a taxpayer acquires a right to acquire an interest in or property of a trust so as to avoid the application of new subsection 104(7.2), any gain realized by the taxpayer on the dispostion of this right or trust interest or property is an income gain.

Subclause 26(2)

ITA 104(17.1)

The purpose of subsection 104(17.1) of the Act is to prevent a trust with both taxable and non-taxable beneficiaries from allocatiing disproportionate amounts of capital cost allowance and depletion allowance to its taxable

beneficiaries. This subsection is amended to extend its application to the allocation of the trust's investment tax credit and employment tax credit. In addition, as a consequence of the introduction of new subsection 104(17.2), the provision is amended to limit its application to testamentary trusts and inter-vivos trusts where no beneficial interest was acquired for consideration payable to the trust or payable to any person who has made a contribution to the trust.

This amendment is applicable in respect of determinations and designations made by a trust for its 1987 and subsequent taxation years.

Subclause 26(3)

ITA
104(17.2)

New subsection 104(17.2) of the Act precludes a trust from transferring certain deductions or tax credits to any of its beneficiaries, unless each trust beneficiary receives a pro-rata share of the amount being transferred, as determined by reference to the beneficiary's share of the income of the trust. This provision is intended to prevent a taxable beneficiary from obtaining, directly or indirectly, a benefit from an expenditure made by a trust that is disproportionate to his share of the income of the trust. The deductions or tax credits affected include capital cost allowance, depletion allowance, investment tax credit and employment tax credit. The provision does not apply to a trust to which new subsection 104(17.1) applies.

This new subsection is applicable with respect to the 1987 and subsequent taxation years of a trust created after November 26, 1985. In the case of a trust created before November 27, 1985 the new subsection does not apply unless the trust issues a beneficial interest therein in a taxation year after its 1986 taxation year (other than an interest issued on account of a distribution of income in accordance with trust terms in effect on November 26, 1985). Where a beneficial interest in a trust is issued after its 1986 taxation year, the new subsection will apply for the taxation year in which the issue occurs and all subsequent taxation years.

Subclauses 26(4) to (6)

These set out the effective dates for the amendments to section 104 of the Act.

Income Interest in a Trust

Clause 27

ITA
106(1)

Subsection 106(1) of the Act provides that an income beneficiary of a trust may claim a deduction against any income received from the trust or any income gain realized on a disposition of his income interest in respect of the cost of that interest where such interest was purchased from any other

beneficiary of the trust. Thus a beneficiary may recover the cost of his interest in a trust before being subject to tax on income derived therefrom. The amendment to subsection 106(1) denies a deduction under this provision to the extent that the beneficiary is entitled to a deduction in calculating taxable income under subsections 112(1) (inter-corporate dividends), 110.1(1) ($1,000 interest and dividend deduction) or 138(6) (dividends received by a life insurer) in respect of the income distributions of the trust.

This amendment is applicable to the 1986 and subsequent taxation years for interests in trusts acquired after 5:00 p.m. EST on November 26, 1985 – the date on which the changes in the rules relating to trusts were announced.

Married Exemption

Clause 28

ITA
109(1)(a)(ii)

Section 109 of the Act sets out the deductions that may be claimed with respect to dependants by an individual in computing his taxable income. Subparagraph 109(1)(a)(ii) sets out the maximum amount of income that a taxpayer's spouse may earn while married to the taxpayer without reducing the married exemption. This subparagraph is amended, for the 1986 and subsequent taxation years, for the purposes of computing the married exemption in the year of marriage, to take into account the income that the spouse earns during the entire year. Previously, only the income of the spouse for the year while married was taken into account in determining the amount of the married exemption.

Disability Deduction

Clause 29

ITA
110(1)(e) and (e.1)

Paragraph 110(1)(e) of the Act allows a special deduction for individuals suffering from a severe and prolonged mental or physical impairment. Paragraph 110(1)(e.1) allows the unused portion of the disability deduction of a dependant to be transferred to his spouse or a parent under certain circumstances. This deduction is adjusted annually and would have amounted to $2,610 for 1986. The amendments to these two paragraphs specify that the amount of the deduction will be increased by $250 for 1986 to $2,860. This amount will be increased in the 1987 and subsequent taxation years by reason of the indexing factor provided in section 117.1 of the Act.

Pension Income Deduction

Clause 30

ITA
110.2(4)(g)

Section 110.2 of the Act deals with the $1,000 pension income deduction for individual taxpayers. Paragraph 110.2(4)(g) is amended, for the 1986 and

subsequent taxation years, to ensure that amounts paid out of or under a salary deferral arrangement are excluded from pension income that is eligible for this deduction.

Northern Employee Travel and Housing Benefits

Clause 31

ITA
110.7

The Act is amended by the introduction of new section 110.7 for the 1987 and subsequent taxation years. This new section provides a special deduction for employee travel benefits and housing benefits for individuals resident in the north and certain other prescribed areas. An employee may claim a deduction in computing his taxable income in respect of certain travel benefits provided to the employee and his family by his employer, to the extent that the value of the benefits is included in his income from employment. Except where trips are made for the purpose of obtaining necessary medical services, the deduction is limited to the amount of the benefit attributable to travelling expenses incurred in connection with not more than two trips made in a calendar year. For each trip, the deduction cannot exceed the cost of the return economy air fare to the nearest designated city.

New paragraph 110.7(b) further provides a special deduction of $225 for each month throughout which an individual resided in a prescribed area in a year. This amount is doubled to $450 for each month during which the taxpayer maintained a self-contained domestic establishment and no other person residing in that establishment claimed a deduction under this paragraph for that month. Thus, where a taxpayer resided with his spouse in a self-contained domestic establishment in a prescribed area, both the taxpayer and his spouse could claim $225 per month or either could claim $450 per month provided that no other person living in that establishment claimed the deduction in respect of that month. The expression "self-contained domestic establishment" is defined in section 248 to mean a dwelling house, apartment or other similar place of residence in which a person as a general rule sleeps and eats. The maximum deduction with respect to living accommodation that an individual may claim in a taxation year cannot exceed 20 per cent of his income for that year.

To be entitled to the deductions provided under this section in a taxation year, the taxpayer is required to file a prescribed form. In addition, he must have resided in a prescribed area throughout a period of not less than six months commencing or ending in the year. The term "prescribed area" will be defined in the *Income Tax Regulations* using criteria similar to those used under the current remission orders relating to northern benefits.

Clause 32

Subclause 32(1)

ITA
111(1)(e)

Under subsection 111(1) of the Act, losses for a taxation year may be carried over and deducted in computing taxable income of other taxation years. This subsection is amended, effective after February 25, 1986, as a consequence of the introduction of the new rules relating to limited partnership losses. New paragraph 111(1)(e) provides for an indefinite carry-forward of limited partnership losses. Limited partnership losses may be carried forward and deducted by a taxpayer against any type of income in a taxation year to the extent that, at the end of the last fiscal period of the partnership ending in that year, the taxpayer has an amount (net of current year losses and tax credits) at risk in respect of the partnership. A taxpayer's at-risk amount is defined in new subsection 96(2.2).

Subclauses 32(2) to (4)

ITA
111(3)

Paragraph 111(3)(a) of the Act provides that a deduction in a taxation year in respect of a loss carryover can only be claimed to the extent that the carryover exceeds the amount thereof that was deducted in preceding taxation years. This provision is amended, effective after February 25, 1986, to refer to limited partnership losses as defined in new subsection 96(2.1). Paragraph 111(3)(b) provides that each type of loss – non-capital, net capital, and so on – must be used in the order in which the losses were incurred. Thus, for example, 1983 net capital losses must be applied before 1984 net capital losses. This rule is retained but expanded to apply to limited partnership losses.

Subclause 32(5)

ITA
111(8)(c)

Sections 2 and 115 of the Act provide that non-residents are subject to Canadian income tax only on income from sources in Canada. Accordingly, paragraph 111(8)(c) of the Act provides that only income and losses from Canadian sources will be included in determining a taxpayer's loss carryover incurred while he was not resident in Canada. The amendment to paragraph 111(8)(c) adds a reference to a taxpayer's limited partnership loss as defined in new subsection 96(2.1). This amendment is applicable after February 25, 1986.

Subclause 32(6)

This sets out the effective dates for the amendments to section 111 relating to loss carryovers.

Individual Tax Rates

Clause 33

Subclause 33(1)

ITA
117(1)

Section 117 of the Act sets out the tax rates for individuals. New subsection (1) is added for taxation years commencing after 1985 to ensure that, except as otherwise provided in Division E relating to the computation of tax, the expression "tax otherwise payable under this Part" or any other similar expression shall be read without reference to the provisions in new Division E.1 relating to the minimum tax. The purpose of this change is to ensure that the calculation of a number of tax adjustments provided under Part I of the Act – such as the foreign tax credit, the investment tax credit and the overseas employment tax credit – are not affected by the new minimum tax.

Subclause 33(2)

ITA
117(6)

Subsection 117(6) of the Act provides the authority for the preparation of a "tax table" to assist individuals in determining their tax payable. This table, which is included in annual tax return packages, sets out the taxes payable for given levels of taxable income. This subsection is amended for taxation years commencing after 1985 to add a reference to new section 120.2 which provides for a seven-year carryforward of the additional tax payable under the provisions relating to the minimum tax.

This ensures that any carryover of additional minimum tax payable by an individual for a year can be deducted from the amount of his tax liability as determined in the table for any other year.

Subclause 33(3)

This sets out the effective date for the amendments to section 117.

Annual Indexing Adjustment

Clause 34

ITA
117.1(1)

Subsection 117.1(1) of the Act contains rules for indexing individual tax brackets, personal exemptions and the child tax credit. The amendments to this subsection, which are effective for the 1986 and subsequent taxation years, are strictly consequential on the $250 increase in the amount of the special deduction granted to individuals suffering from a severe and prolonged mental or physical impairment. The increased deduction of $2,860 for 1986 will be reflected in the base for calculating the annual indexing adjustments for 1987 and subsequent years.

Adjustments to Individual Income Tax

Clause 35

ITA 120(4)(c)

Section 120 of the Act provides for two adjustments to the federal tax payable by individuals. These are the additional tax payable on income that is not taxable by the provinces, and the special Quebec abatement. These adjustments are determined as a percentage of the amount of tax otherwise payable under Part I of the Act. For this purpose, the amount of tax otherwise payable is determined in paragraph 120(4)(c). The amendment to this paragraph, which is effective for taxation years commencing after 1985, is consequential on the introduction of the minimum tax. As amended, paragraph 120(4)(c) provides that, for the purposes of these two adjustments, the tax otherwise payable means the greater of the regular tax before certain deductions and the minimum tax before any adjustment resulting from a forward averaging election. This means that taxpayers subject to the minimum tax for a year will calculate both the Quebec abatement and the additional tax for income not earned in a province by reference to the minimum tax.

Minimum Tax Carryover

Clause 36

ITA 120.2

New section 120.2 of the Act provides for the carryforward of any additional taxes paid under the provisions relating to the minimum tax. Under new subsection 120.2(1), any additional tax payable by an individual for a year by reason of the provisions relating to the minimum tax may be carried forward and deducted from his regular tax liability in the seven subsequent years. Where a taxpayer dies, new subsection 120.2(2) provides that any unused carryover may be deducted from his regular tax liability for the three years preceding the year of death.

The carryover of additional taxes under new subsections 120.2(1) and (2) for a year cannot be used in another year to reduce the taxpayer's tax payable below his minimum amount for that other year. The amount of additional tax payable for a year that is available for the carryover is determined under new subsection 120.2(3). An individual's additional tax is defined as the excess of his minimum amount as determined under new section 127.51 over the total of his regular tax liability and the additional foreign tax credit allowed in excess of his normal foreign tax credit under section 126 of the Act.

The following two examples illustrate the carryover mechanism. Example 1 shows the way in which 1986 additional minimum taxes may be carried forward to 1987 and 1988. Example 2 illustrates a carryback to 1986 and 1985 of additional minimum taxes payable in 1987 in the case of a taxpayer who died in 1988.

Example 1

	1986		1987		1988	
	Regular Tax	AMT	Regular Tax	AMT	Regular Tax	AMT
Provisional federal tax	200	900	800	700	700	0
Less: AMT carryover from previous years	N/A		100		600	
Basic federal tax	900		700		100	
Unused carryforward	700		600		0	

Example 2 shows that a carryback to preceding years is available even where the deceased taxpayer is not subject to the minimum tax in the year of death.

New subsection 120.2(4) provides that the carryover of additional minimum tax may not be used to reduce tax payable in respect of the separate returns of income filed on behalf of a bankrupt or deceased taxpayer.

Example 2

	1985		1986		1987		1988	
	Regular Tax	AMT	Regular Tax	AMT	Regular Tax	AMT	Regular Tax	AMT
Provisional federal tax	900	N/A	400	0	100	800	300	200
Less: AMT carryover from 1987	200		400				100	
Basic federal tax	700		0		800		200	

Dividend Tax Credit

Clause 37

ITA
121

Section 121 of the Act is part of the gross-up and tax credit mechanism for the taxation of dividends received by individuals from taxable Canadian corporations. In general terms, under amended paragraph 82(1)(b) of the Act a dividend received by an individual shareholder is grossed up by one-third and the grossed-up dividend is included in his income. The amount of the gross-up – that is, one-third of the dividend – approximates the tax credit that is allowed against the federal and provincial income taxes payable by the individual. The federal share of the dividend tax credit is provided in section 121 of the Act. Until the end of 1986, the federal dividend tax credit will remain at 68 per cent of the amount of the gross-up. Section 121 is amended for 1987 and subsequent years to provide a federal credit of two-thirds of the

amount of the gross-up. The amount of the provincial dividend tax credit will depend on the applicable rate of provincial tax. However, when provincial taxes are taken into account, the total dividend tax credit, federal and provincial taken together, will approximate one-third of the actual dividend received.

Overseas Employment Tax Credit

ITA
122.3(2)(b)

Clause 38

An overseas employment tax credit may be claimed under section 122.3 of the Act by individuals resident in Canada who work abroad for six consecutive months or longer for a specified employer in connection with a resource, construction, installation, agricultural or engineering project. This credit is based upon the proportion of tax otherwise payable that an individual's qualifying overseas employment income is of his total income. Paragraph 122.3(2)(b) defines the expression "tax otherwise payable under this Part for the year" for the purposes of this computation. For taxation years commencing after 1985, this paragraph is amended to add a reference to new section 120.2 to ensure that the carryover of the additional minimum tax from a year does not reduce the amount of the overseas employment tax credit that may be claimed by a taxpayer in any other year. This amendment and the amendments to section 117 mean that the calculation of the overseas employment tax credit remains unaffected by the provisions relating to the minimum tax.

Federal Sales Tax Credit

ITA
122.4

Clause 39

New section 122.4 of the Act implements the refundable federal sales tax credit for individuals announced in the February, 1986 budget for the 1986 and subsequent taxation years. This provision is intended to assist lower-income families. The new section provides a refundable tax credit of $50 to an eligible individual. The individual may also be entitled to additional credits for his qualified relations – $50 for his spouse with whom he resides and $25 for each person under 18 years of age who is wholly dependent on him or his spouse. The individual's total credit is reduced by five cents for each dollar of income of the taxpayer and his spouse in excess of $15,000. For the purposes of the credit, an "eligible individual" is defined in new subsection 122.4(1) as an individual (other than a trust) who is married, a parent or 18 years old. Further, a "qualified relation" of an individual is generally defined as his spouse, his child or a person in respect of whom he claimed a section 109 deduction. A spouse who is living separate and apart from an individual at the end of a taxation year is not a qualified relation of that individual for the year.

New subsection 122.4(2) of the Act provides that individuals who are not resident in Canada throughout a particular year or are confined to a prison or similar institution for more than six months in the year are not eligible for

the credit. Similarly the credit is not available to officers or servants (including members of their families and servants) of the government of a foreign country who are not subject to individual income tax under Part I of the Act.

Under new subsection 122.4(3) of the Act, to receive a credit for a taxation year, an eligible individual must complete, jointly with his spouse with whom he resides, a form that must be filed with his income tax return for the year. The credit of an individual for a taxation year is considered to have been paid by him as tax for the year. As a consequence, the credit will reduce the individual's tax otherwise payable or, if he is not liable for tax, it will be paid to him as a refund. Under new subsection 122.4(4) of the Act, where two individuals are married to each other and are not separated only one may claim the credit but this individual may claim the additional $50 credit for the spouse.

Corporate Tax Rate Reduction

Clause 40

Subclause 40(1)

ITA
123(1)

Subsection 123(1) of the Act establishes the rate of income tax payable by a corporation under Part I of the Act. The amendments to this subsection provide for the reduction in the ordinary corporate tax rate that is to be phased in over the period from July 1987 to June 1989. Paragraph (a) thereof sets the basic rate of corporate tax and is amended to reduce this rate from 46 per cent to 43 per cent of the corpration's taxable income for the year. Paragraph (b), which imposes an additional 5-per-cent rate of tax on income earned in the Nova Scotia offshore area, is not affected by this amendment.

New paragraph 123(1)(c) of the Act establishes an additional tax rate of 3 per cent in respect of the investment income of Canadian-controlled private corporations. The purpose of this addition to the tax otherwise payable under Part I of the Act is to maintain the federal rate of tax on such income at 46 per cent before any reduction in respect of the 10-per-cent provincial abatement under section 124 of the Act.

The amount determined under new paragraph 123(1)(c) for a taxation year is calculated as 3 per cent of the lesser of

- the amount by which the corporation's taxable income for the year exceeds the total of its income which qualifies for the small business deduction plus two times the amount deducted under subsection 126(2) in respect of foreign tax paid on foreign business income, and
- the amount by which the corporation's Canadian and foreign investment income for the year exceeds the total of its investment losses plus any net capital losses of other years that were deducted by the corporation in the year.

The following example illustrates the application of new paragraph 123(1)(c). The example assumes that a Canadian-controlled private corporation has $400,000 of taxable income comprised of $300,000 of active business income earned in Canada, $300,000 of Canadian investment income and a $200,000 non-capital loss carried over from another taxation year. The amount determined under new paragraph 123(1)(c) is 3 per cent of the lesser of:

(A) Amount taxable	$400,000
Less amount qualifying for small business deduction and 2 times foreign business income tax credit	200,000
	$200,000
(B) Canadian and foreign investment income	$300,000
Less losses from property in the year and net-capital losses for other years deducted in the year	NIL
	$300,000

Therefore, in this example the amount determined under new paragraph 123(1)(c) would equal 3 per cent of $200,000, or $6,000.

This example illustrates that the "investment income tax" will apply only to the net investment income of Canadian-controlled private corporations and only to the extent that taxable income exceeds that portion of the corporation's income which benefits from the small business tax rate (or, in the case of foreign business income, which is considered to have borne the allowable amount of foreign tax).

New paragraph 123(1)(d) establishes a similar 3-per-cent additional tax rate on the net taxable capital gains of investment corporations and mutual fund corporations. These corporations are treated as conduits with respect to capital gains, being subject to tax on these gains when realized and entitled to claim a refund of federal tax paid on this income when it is distributed to shareholders in the form of a capital gains dividend. New paragraph 123(1)(d), in conjunction with paragraph 123(1)(a), maintains at 36 per cent the rate of federal tax payable on capital gains, after the 10-per-cent provincial abatement provided in section 124 of the Act.

Subclause 40(2)

This sets out the effective dates for the amendments to subsection 123(1) of the Act. A transitional provision modifies the effective rates of tax payable under paragraphs 123(1)(a), (c) and (d) for taxation years beginning before July 1, 1989. This provision has the effect of levying a basic corporate tax rate under paragraph 123(1)(a) of 45 per cent from July 1, 1987 to June 30, 1988, 44 per cent from July 1, 1988 to June 30, 1989 and 43 per cent after June 30, 1989, and an "investment income tax" rate under paragraphs 123(1)(c) and (d) of 1, 2 and 3 per cent for the same respective periods. For those corporations with taxation years that do not coincide with these periods, this provision also determines the rate which will apply to income earned during such taxation years.

The application of this transitional provision may best be explained by way of an example. The following example assumes that a Canadian-controlled private corporation has a fiscal period coinciding with the calendar year and has $100,000 of taxable income in each of its 1987, 1988 and 1989 years comprised of $80,000 of business income and $20,000 of investment income. The tax payable by the corporation under subsection 123(1) is as follows:

	1987	1988	1989
		(dollars)	
43% of taxable income (Paragraph 123(1)(a))	43,000	43,000	43,000
3% of investment income (Paragraph 123(1)(c))	600	600	600
Add: 3% of taxable income times number of days in year before July 1, 1987 over number of days in year	1,487.67	NIL	NIL
Add: 2% of taxable income times number of days in year after June 30, 1987 and before July 1, 1988 over number of days in year	1,008.22	994.36	NIL
Add: 1% of taxable income times number of days in year after June 30, 1988 and before July 1, 1989 over number of days in year	NIL	502.73	495.89
Deduct: 3% of amount determined under paragraph 123(1)(c) times number of days in year before July 1, 1987 over number of days in year	(297.53)	NIL	NIL
Deduct: 2% of amount determined under paragraph 123(1)(c) times number of days in year after June 30, 1987 and before July 1, 1988 over number of days in year	(201.64)	(198.91)	NIL
Deduct: 1% of amount determined under paragraph 123(1)(c) times number of days in year after June 30, 1988 and before July 1, 1989 over number of days in year	NIL	(100.55)	(99.18)
Tax payable under subsection 123(1)	45,596.72	44,797.63	43,996.71

5-Per-Cent Corporate Surtax

Clause 41

ITA
123.1

Section 123.1 of the Act provides a 5-per-cent federal corporate surtax which applies for the period from July 1, 1985 to December 31, 1986. The amendment to section 123.1 is consequential on the continuation after 1986 of a federal corporate surtax at a rate of 3 per cent under new section 123.2. The amendment ensures that the new surtax is not taken into account in determining the amount of federal tax that is subject to the existing surtax.

3-Per-Cent Corporate Surtax

Clause 42

Subclause 42(1)

ITA
123.2

New section 123.2 of the Act provides a surtax of 3 per cent of federal income tax payable by corporations other than non-resident-owned investment corporations. This surtax applies after December 31, 1986.

The amount of federal tax subject to the new surtax is determined after the 10-per-cent abatement under section 124 (which, for the purposes of this section, applies to all of a corporation's taxable income), but before the 5-per-cent addition in respect of taxable income earned in the Nova Scotia offshore area under paragraph 123(1)(b) and the corporate surtax provided under section 123.1 and before any deduction in respect of foreign tax credits, investment tax credits, employment tax credits, share-purchase tax credits or credits for political contributions.

The surtax does not apply to that portion of the tax payable by a Canadian-controlled private corporation in respect of its investment income that is included in its refundable dividend tax on hand for a taxation year under section 129 of the Act. An exemption from the corporate surtax is also provided for the federal tax payable by an investment corporation or a mutual fund corporation on its "taxed capital gains" for a taxation year.

Subclause 42(2)

This sets out the effective date for new section 123.2 of the Act. A transitional provision applies for those corporations with a taxation year which falls within both the 1986 and 1987 calendar years. Where this occurs, the corporation will be required to pay only that portion of the surtax that relates to 1987, based on the number of days in each calendar year.

Small Business Deduction

Clause 43

Subclause 43(1)

ITA
125(1)

Section 125 of the Act provides the special low rate of tax on the income of a Canadian-controlled private corporation from carrying on an active business in Canada. The low rate is provided by way of a small business deduction of 21 per cent on up to a maximum of $200,000 of income eligible for the low rate. Subsection 125(1) is amended to reduce this deduction to 20 per cent after June 30, 1989. This change, when taken in conjunction with the corporate tax rate reductions provided in subsection 123(1), results in an effective federal tax rate applying to income eligible for the small business deduction at 14 per cent for the period from July 1, 1987 to June 30, 1988 and 13 per cent beginning July 1, 1988.

Subclause 43(2)

ITA
125(1)(b)

Paragraph 125(1)(b) of the Act is one of three limitations used in determining the portion of a corporation's income that qualifies for the small business deduction. This limitation ensures that the small business deduction will be available only with respect to the amount by which a corporation's taxable income exceeds any income which may be considered to have borne foreign tax equivalent to Canadian federal tax and which, therefore, will not be subject to Canadian federal tax. For the purposes of subsection 125(1), the foreign income which is considered not to have borne Canadian federal tax is based upon the foreign tax credit which the corporation has claimed under subsection 126(1) or (2) of the Act. This amendment to subparagraph 125(1)(b)(i) provides that, in determining the non-business income foreign tax credit under subsection 126(1) for the purposes of section 125, the additional tax on investment income under paragraph 123(1)(c) of the Act is to be ignored. This amendment is applicable with respect to taxation years ending after June 1987.

Subclauses 43(3) and (4)

Subclause 43(3) sets out the effective date for the amendment to the rate of the small business deduction, and contains a transitional provision which applies to those corporations with a taxation year which begins before July 1, 1989 and ends after June 30, 1989. Subclause 43(4) sets out the effective date for the amendment to subparagraph 125(1)(b)(i) of the Act.

Manufacturing and Processing Tax Credit

Clause 44

Subclauses 44(1) and (2)

ITA
125.1(1)

Section 125.1 of the Act provides a reduced rate of corporate tax on Canadian manufacturing and processing profits. The amendments to subsection 125.1(1) have the effect of increasing this rate reduction from 6 per cent

to 7 per cent on that portion of such income that does not benefit from the small business deduction provided under section 125 of the Act. The existing federal rate of corporate tax on such profits is 30 per cent and is reduced to 10 per cent for manufacturing and processing profits eligible for the small business deduction. The effect of this amendment, taken together with the basic corporate rate reduction provided by the amendments to subsection 123(1), is to reduce the federal rate of tax on manufacturing and processing profits not eligible for the small business deduction to 28 per cent for the period from July 1, 1987 to June 30, 1988, 27 per cent for the period from July 1, 1988 to June 30, 1989, and 26 per cent beginning July 1, 1989.

Subclause 44(3)

ITA
125.1(1)(b)

Paragraph 125.1(1)(b) of the Act provides a tax rate reduction equal to 5 per cent of that portion of a corporation's Canadian manufacturing and processing profits that benefit from the small business deduction under section 125. This subclause increases the deduction under paragraph 125.1(1)(b) to 6 per cent for the period from July 1, 1987 to June 30, 1988. This change, taken in conjunction with the basic corporate rate reduction provided by the amendments to subsection 123(1) and the amendment to the small business deduction under subsection 125(1), reduces the federal rate of tax on manufacturing and processing profits eligible for the small business deduction to 8 per cent effective July 1, 1987.

Subclause 44(4)

This sets out the effective date for the amendments to subsection 125.1(1) and contains a transitional provision for those corporations with a taxation year ending after June 30, 1987 which begins before July 1, 1987 – the date on which the corporate tax reductions first take effect.

Foreign Tax Credit

Clause 45

Subclause 45(1)

ITA
126(2.3)(b)
and (c)

Section 126 of the Act permits a taxpayer to claim a foreign tax credit. Subsection 126(2.3) of the Act sets out rules that are used in determining the unused foreign tax credit available for carryover to other taxation years. The amendments to paragraphs (b) and (c) of that subsection are strictly consequential on the amendment to Part I.1, which permits the unused portion of the credit of an individual to be applied against the surtax payable under section 180.1 of the Act. To the extent that the foreign taxes offset the surtax in a year, the unused foreign tax credit that can be carried forward for deduction in subsequent taxation years will be reduced. This amendment is applicable to the 1986 and subsequent taxation years.

Subclause 45(2)

ITA 126(7)(c)(vi)

Subsection 126(1) sets out the rules for determining the credit in respect of foreign non-business income tax – that is, the foreign tax on foreign source income other than from a business carried on outside Canada. For the purposes of computing this credit, existing subparagraph 126(7)(c)(vi) excludes any foreign tax paid in respect of remuneration from outside Canada that qualifies for the overseas employment tax credit provided in section 122.3. The amendment to this subparagraph, which is effective for taxation years commencing after 1985, is consequential on the introduction of the minimum tax. The change allows an individual, if he so chooses, to claim a foreign tax credit in respect of certain foreign taxes rather than the overseas employment tax credit which would otherwise be available. A taxpayer may elect to do this, for example, in circumstances where his overseas employment tax credit would be rendered ineffective by virtue of the application of the minimum tax. In the example below which illustrates these alternatives, it is assumed that foreign taxes of $500 were paid which would qualify for the foreign tax credit if the taxpayer forgoes any claim for the overseas employment tax credit.

Example

	Overseas Employment Tax Credit		Foreign Tax Credit	
	Regular Tax	AMT	Regular Tax	AMT
Tax on taxable income	900	800	900	800
Less: Overseas employment tax credit	600	0	0	0
Provisional federal tax	300	800	900	800
Basic federal Tax	800		900	
Foreign tax credit	0		500	
Federal tax payable	800		400	
AMT carryover available for subsequent years	500		0	

In this example, by claiming the foreign tax credit, the tax is reduced by $400 but the individual forgoes the minimum tax carryover of $500 that could be used to reduce his tax in another taxation year.

Subclause 45(3)

ITA 126(7)(d)(i) to (iii)

Paragraph 126(7)(d) of the Act defines the "tax for the year otherwise payable" under Part I by a taxpayer for a taxation year for the purposes of determining his foreign tax credit under section 126. Subparagraph

126(7)(d)(i) defines the amount of "tax for the year otherwise payable" for the purposes of determining a taxpayer's non-business income foreign tax credit – that is, the credit with respect to foreign source income other than business income. The amendment provides that this amount is computed before making any addition under paragraph 123(1)(b) relating to the tax payable on income earned in the Nova Scotia offshore area.

Subparagraphs 126(7)(d)(ii) and (iii) of the Act define the amount of "tax for the year otherwise payable" for the purposes of determining a taxpayer's business-income foreign tax credit – that is, the credit with respect to foreign source business income. These paragraphs are amended to provide that this amount is computed before any addition under paragraph 123(1)(b) relating to the tax payable on income earned in the Nova Scotia offshore area, or under new paragraphs 123(1)(c) or (d) of the Act relating to the tax payable by a Canadian-controlled private corporation on its investment income and to the tax payable by an investment corporation or a mutual fund corporation on its net taxable capital gains, respectively.

These amendments are applicable to the 1986 and subsequent taxation years.

Subclause 45(4)

ITA
126(7)(e)

Paragraph 126(7)(e) of the Act provides the definition of "unused foreign tax credit". The amendment to this paragraph is strictly consequential on the amendment to Part I.1, under which the unused portion of the credit of an individual may be applied against the surtax payable under section 180.1 of the Act. The amendment requires the unused foreign tax credit of an individual for a year to be reduced to the extent of any foreign tax paid on income from a business carried on outside Canada that reduced his surtax payable for that year. This amendment is applicable to the 1986 and subsequent taxation years.

Subclauses 45(5) to (7)

These set out the effective dates for the amendments to section 126 of the Act.

Investment Tax Credit

Clause 46

Subsections 127(6) to (12.2) of the Act provide the rules for determining the investment tax credit (ITC) of a taxpayer.

Subclause 46(1)

ITA
127(8)

Subsection 127(8) of the Act provides a rule for allocating the investment tax credit of a partnership to its partners. This subsection is amended to exclude from this allocation the new ITC earned in respect of a qualified Canadian exploration expenditure incurred by a partnership. Under paragraph 66.1(6)(a) the Canadian exploration expense of each partner includes his share of the Canadian exploration expense incurred by the partnership. Since the partner rather than the partnership earns this investment tax credit, it is appropriate to exclude this credit from the allocation under subsection 127(8). This amendment is applicable on and after December 1, 1985 – the date on which the new credit takes effect.

Subclause 46(2)

ITA
127(8.1) to (8.5)

New subsections 127(8.1) to (8.5) of the Act implement the February 1986 budget proposals relating to the allocation of investment tax credits to limited partners and are applicable after February 25, 1986.

New subsection 127(8.1) of the Act restricts the amount of investment tax credits that may be allocated by a partnership at the end of its fiscal period to a limited partner as defined in new subsection 96(2.4). This provision limits the allocation at the end of a partnership's fiscal period to the lesser of the following two amounts:

- the portion of the ITC that would have been allowable to the limited partner if the at-risk rules had not applied to any partner of the partnership and that may be considered to have been earned by the partnership in respect of its expenditure in that period of an amount equal to the limited partner's expenditure base for the year (as defined in new subsection 127(8.2)), and
- the limited partner's remaining at-risk amount (as defined in new subsection 96(2.2)) in respect of the partnership at the end of the period.

In determining those ITCs that were earned by a partnership in respect of the expenditure by it of an amount equal to the expenditure bases of its limited partners, a partnership is entitled to allocate the high ITC rate expenditures in favour of limited partners. Thus, for example, if the expenditure base of the limited partners were $100,000 for a year in which the partnership acquired $150,000 of property qualifying for ITCs at the 40-per-cent rate and a further $50,000 of property qualifying for ITCs at the rate of 10 per cent, the partnership could allocate a maximum of $40,000 (that is, 40 per cent of $100,000) of investment tax credits to the limited partners for that year.

New subsection 127(8.2) of the Act defines, for the purposes of the rules in new subsection 127(8.1) as described above, a limited partner's expenditure base for a taxation year of the partnership (its fiscal period). This amount is defined as at the end of a partnership taxation year and means:

- the limited partner's initial at-risk amount in respect of his partnership interest
  - plus any subsequent contributions to the partnership before the end of the year,
  - plus his share of the income net of losses from the partnership for the year and preceding years,
  - less all distributions to him before the end of the year from the partnership, and
  - less any amount previously considered to have been an expenditure by the partnership of funds in respect of the limited partner's expenditure base.

However, in no event can a limited partner's expenditure base exceed his proportionate share of the aggregate expenditure base of all limited partners of the partnership.

New subsection 127(8.3) of the Act provides rules for the allocation of investment tax credits remaining after the allocation of such credits to limited partners. In such circumstances the remaining investment tax credit may be allocated to those non-limited partners – that is, the general partner or partners – who were members of the partnership throughout the fiscal period of the partnership, in proportion to their investment (whether by debt or equity) in the partnership. For those general partners who were not partners throughout the fiscal period of the partnership, the normal rules allocating investment tax credits according to equity participation would apply. Nevertheless, there may be situations where the general partners would rather have the remaining investment tax credits extinguished than to have them allocated. This could happen, for example, in those circumstances where the general partner is not in a position to use the credits. New subsection 127(8.4) provides for an election under which a general partner who has been allocated investment tax credits pursuant to the provisions of subsections 127(8) and (8.3) may renounce the credits allocated to him. In such circumstances, the investment tax credits are extinguished and a cost base reduction of partnership property is not required.

New subsection 127(8.5) of the Act provides that, for the purposes of new subsections 127(8.1) to (8.4), the terms "at-risk amount" and "limited partner" have the meanings assigned by subsections 96(2.2) and (2.4), respectively.

Subclauses 46(3) to (13)

ITA 127(9)

Subsection 127(9) of the Act provides the various definitions used in the provisions relating to investment tax credits. This subsection is amended to phase out by 1989 the general 7-per-cent investment tax credit, the 10-per-cent investment tax credit in respect of prescribed designated regions and the 7-per-cent credit for qualified transportation equipment and qualified construction equipment. It is also amended to extend the credit at a rate of 20 per cent to qualified property used in a prescribed area offshore of the Atlantic Provinces and the Gaspé Peninsula, to extend the special investment tax credit for manufacturing property acquired for use in prescribed areas beyond the original termination date (but at a reduced rate of 40 per cent), to reduce from $50,000 to $25,000 the project threshold for eligibility for the special 60-per-cent Cape Breton investment tax credit and to implement the 25-per-cent credit for qualifying Canadian exploration expenditures.

The amendment to the preamble of subsection 127(9) of the Act extends the application of the definitions in that subsection to section 127.1 which deals with the refundable portion of investment tax credits. This amendment is consequential on the amendment to paragraph 127.1(2)(b) which provides that unused Cape Breton investment tax credits earned after May 23, 1985 and before 1989 in respect of "approved project property" are refundable for all taxpayers, other than tax-exempt persons, at a 40-per-cent refund rate.

"approved project"

The definition of "approved project" is amended to reduce from $50,000 to $25,000 the minimum capital cost of depreciable property required to be used in a project in order to be eligible for the special 60-per-cent Cape Breton investment tax credit. This amendment is applicable for projects approved after February 25, 1986.

"certified property"

The definition of "certified property" in subsection 127(9) of the Act defines the property that qualifies for the special 50-per-cent investment tax credit for manufacturing property acquired for use in prescribed areas. This definition is amended to extend the investment tax credit at a rate of 40 per cent to certified property acquired after 1986. However, certified property that is acquired in 1987 pursuant to transitional provisions introduced in the May 23, 1985 budget (and incorporated into the amended definition) will continue to be eligible for the special investment tax credit at the rate of 50 per cent.

"investment tax credit"

Paragraphs (a) and (c) of the definition "investment tax credit" in subsection 127(9) of the Act are amended to include the specified percentage of a taxpayer's qualified Canadian exploration expenditure in his investment tax credit. These amendments are consequential on the introduction of the new 25-per-cent investment tax credit in respect of such expenditures. The amendment to paragraph (a) is applicable after November 30, 1985 and the amendment to paragraph (c) is applicable to taxation years ending after November, 1982.

"qualified Canadian exploration expenditure"

The term "qualified Canadian exploration expenditure" is added to subsection 127(9) of the Act to define an expenditure that qualifies for the new 25-per-cent investment tax credit as one that is prescribed by Income Tax Regulation. Reference may be made to the draft Regulation. This amendment is applicable on and after December 1, 1985 – the date on which exploration expenditures first qualified for the investment tax credit.

"qualified construction equipment"

The definition of "qualified construction equipment" in subsection 127(9) of the Act is amended to exclude any property acquired after 1988. This amendment is consequential on the amendments to the definition "specified percentage" in subsection 127(9) that phase out the general 7-per-cent investment tax credit by 1989. This amendment is applicable after February 25, 1986.

"qualified transportation equipment"

The definition of "qualified transportation equipment" in subsection 127(9) of the Act is amended to exclude any property acquired after 1988. This amendment is consequential on the amendments to the definition "specified percentage" in subsection 127(9) that phase out the general 7-per-cent investment tax credit by 1989.

"specified percentage"

The definition of "specified percentage" in subsection 127(9) of the Act provides the relevant rules for calculating investment tax credits in different circumstances. Subparagraph (a)(iii) sets out the rates applicable in respect of qualified property. This subparagraph is amended to increase, from 7 per cent to 20 per cent, the rate applicable in respect of qualified property acquired after February 25, 1986 for use in a prescribed area of Canada offshore of the provinces of Newfoundland, Prince Edward Island, Nova Scotia and New Brunswick and of the Gaspé Peninsula.

New subparagraphs (a)(iv) to (vii) are added to the definition of "specified percentage" to provide for the phasing out of the general 7-per-cent investment tax credit and the 10-per-cent investment tax credit applicable in respect of property acquired for use in prescribed designated regions of Canada. The rate of credit for qualified property currently entitled to the general 7-per-cent investment tax credit will be reduced to 5 per cent for property acquired in 1987, 3 per cent for property acquired in 1988 and nil for property acquired after 1988. The rate of credit for qualified property acquired for use in a prescribed designated region will be reduced from the current rate of 10 per cent to 7 per cent for property acquired in 1987, 3 per cent for property acquired in 1988 and nil for property acquired after 1988.

Paragraphs (b) and (c) of the definition of "specified percentage" are amended to phase out the 7-per-cent investment tax credit for qualified transportation equipment and qualified construction equipment in the same manner as the phase-out for qualified property currently entitled to the general 7-per-cent investment tax credit.

Paragraph (d) of the definition of "specified percentage" is amended to extend the special investment tax credit at the rate of 40 per cent for certified

property acquired after 1986, other than certified property acquired in 1987 that is already eligible for the 50-per-cent special investment tax credit pursuant to transitional provisions introduced in the May 23, 1985 budget.

The definition of "specified percentage" is also amended by adding paragraph (h) to provide for an investment tax credit of 25 per cent in respect of a "qualified Canadian exploration expenditure" as that expression is defined in subsection 127(9). This amendment is applicable on and after December 1, 1985 – the date on which this credit became effective.

Subclause 46(14)

ITA
127(11.1)

Subsection 127(11.1) of the Act provides special rules for determining the capital cost of property and the amount of an expenditure for the purpose of the definition of "investment tax credit". This provision requires the cost of a property acquired or the amount of an expenditure made to be reduced by any government assistance, non-government assistance or contract payment relating to such cost or amount. New paragraph (c.1) is added to reduce a taxpayer's "qualified Canadian exploration expenditure" (as defined in subsection 127(9)) by the amount of the assistance relating to the expenditure, other than assistance under the federal *Petroleum Incentives Program Act* or the *Petroleum Incentives Program Act* of the Province of Alberta. Assistance under these Acts already reduces the taxpayer's qualified Canadian exploration expenditure under the relevant Income Tax Regulation. Where assistance that has reduced a qualified Canadian exploration expenditure under this subsection is repaid, the taxpayer's investment tax credit will be adjusted accordingly under paragraph (e.1) of the definition of investment tax credit in subsection 127(9).

This amendment is applicable with respect to expenditures made after November 30, 1985.

Subclause 46(15)

ITA
127(12.3)

New subsection 127(12.3) of the Act ensures that the cumulative Canadian exploration expense of a trust is reduced by the amount of any investment tax credit earned by the trust in respect of a qualified Canadian exploration expenditure and allocated to a beneficiary of the trust. A partnership is not affected by this amendment because the partners and not the partnership earn the credit. This amendment is applicable with respect to expenditures made after November 30, 1985.

Subclauses 46(16) to (20)

These set out the effective dates for the amendments to section 127 of the Act relating to the investment tax credit.

Refundable Investment Tax Credit

ITA
127.1(2)

Clause 47

Section 127.1 of the Act provides for the refund of unused investment tax credits earned in the period commencing on April 20, 1983 and ending on April 30, 1986. Under the existing provisions, the general rate of refund is 20 per cent but is increased to 40 per cent for credits earned by individuals and certain Canadian-controlled private corporations and trusts.

The definition of "refundable investment tax credit" in subsection 127.1(2) is amended to provide a 40-per-cent rate of refund for investment tax credits earned in respect of a qualified Canadian exploration expenditure. This rate applies to all taxpayers (other than tax-exempt persons who are not entitled to any refund of investment tax credits). Further, the expiry date for refundable investment tax credits is extended to the end of 1988. As the investment tax credit in respect of a qualified Canadian exploration expenditure is calculated on an annual basis rather than on an "expenditure-by-expenditure" basis, no portion of this credit is refundable for taxation years commencing after 1988. The definition is also amended to provide a 40-per-cent rate of refund for unused investment tax credits earned in respect of an approved project (the 60-per-cent Cape Breton investment tax credit). These amendments are generally applicable after May 23, 1985.

Minimum Tax

ITA
Division E.1

Clause 48

New Division E.1 of the Act contains the basic provisions for imposing a minimum tax. These provisions are applicable to taxation years commencing after 1985. Section 127.5 provides that an individual's tax for a year shall not be less than his minimum tax for the year. The first step in computing the individual's minimum tax for a year is the calculation of his adjusted taxable income for the year under section 127.52 on the basis of the various assumptions set out in paragraphs (a) to (j) thereof. The next step is the deduction of his basic exemption (defined in section 127.53) from his adjusted taxable income for the year. The remainder is then multiplied by 17 per cent to obtain the individual's minimum amount as defined in section 127.52.

Section 127.5 provides for the calculation of the minimum tax payable by an individual under Part I for a taxation year. The minimum tax is determined as the difference between A and B where

> A is the aggregate of the minimum amount as determined under section 127.51, the tax payable under section 120 for income not earned in a province and the tax payable under section 120.1 in respect of a forward averaging election, and B is the aggregate of the special tax deduction under subsection 120.1(1) in respect of a forward averaging election and the amount of the special foreign tax credit as determined under new section 127.54.

Section 127.51 provides that an individual's "minimum amount" of tax for a particular year is 17 per cent of the amount by which his adjusted taxable income for the year exceeds his basic exemption for the year.

Subsection 127.52(1) defines the "adjusted taxable income" of an individual for a taxation year, which is relevant in determining his minimum amount under section 127.51. An individual's adjusted taxable income for a year means the amount that would be his taxable income for the year if

(a) no deduction were allowed in respect of contributions to a registered pension plan, a deferred profit sharing plan or a registered retirement savings plan otherwise than in respect of funds transferred between such plans;

(b) no deduction were allowed for depletion, exploration, development, other similar resource expenses and for capital cost allowance in respect of certified Canadian films and multiple unit residential buildings except to the extent that such a deduction does not give rise to a loss or to an increased loss;

(c) the total amount of capital gains and losses (other than capital gains and losses realized on the disposition of certain cultural property) were included in income;

(d) only the actual amount of taxable dividends received from taxable Canadian corporations (excluding the gross-up) were included in income;

(e) the only deductions allowed in computing taxable income were the personal exemptions, the education and disability deductions (but not including transfers of these deductions), medical expenses, charitable donations, the deduction for individuals who have taken the vow of perpetual poverty, the deductions allowed under paragraph 110(1)(f) in respect of social assistance and certain other benefits, the deduction for unemployment insurance benefit repayments, the forward averaging deduction, the lifetime capital gains exemption and the carryover of losses from other years; and

(f) the special transitional rules relating to certain lump sum payments out of pension plans and other employee compensation plans were not applicable.

The adjustments described in paragraphs (b) and (c) above are also applicable in determining the deductions for non-capital and net capital losses from other years in computing adjusted taxable income. This is illustrated in the example below.

Example

	Taxable Income Loss Year		Taxable Income Carryover year	
	Regular	Adjusted	Regular	Adjusted
	($ thousands)			
Non-capital loss	(100)	(80)	0	0
Income from other sources	0	0	120	145
Loss carryover available			(100)	(80)
Basic AMT exemption			N/A	(40)
Taxable income	0	0	$20	$25

Subsection 127.52(2) provides a special rule where a partnership has invested in a residential building or Canadian film. For the purpose of computing adjusted taxable income under the minimum tax, an individual who is a member of the partnership and entitled to a share of the income of the partnership is treated as having claimed the capital cost allowance claimed by the partnership in the same proportion as his share of such income. This provision is necessary to ensure that the capital cost allowance limitation with respect to such properties will be effective for investments made through a partnership.

Subsection 127.52(3) defines the terms "film property" and "residential property" as property described in paragraph (n) of Class 12, and in Classes 31 and 32, respectively, of Schedule II to the Income Tax Regulations. These definitions are relevant for the purposes of the capital cost allowance limitation with respect to residential and film properties in calculating adjusted taxable income under the minimum tax.

Section 127.53 provides a $40,000 basic exemption in computing taxable income subject to the minimum tax for individuals and certain qualifying trusts – namely testamentary trusts and those *inter vivos* trusts to which subsection 122(2) applies. Other *inter vivos* trusts are not entitled to this exemption. Where more than one qualifying trust arises as a consequence of contributions to the trusts by the same individual, subsections 127.53(2) and (3) provide rules for apportioning the $40,000 exemption as between the trusts. These rules are patterned on the rules in subsection 125(3) of the Act for apportioning the annual business limit as between associated corporations for the purposes of the small business deduction.

Section 127.54 provides that an individual subject to the minimum tax may claim a special foreign tax credit in an amount equal to or, in certain circumstances, greater than the credit to which he is entitled under the usual rules in section 126 of the Act. Under the special credit, an individual may deduct from his federal minimum tax payable an amount equal to the lesser of

17 per cent of his foreign income for the year and the foreign tax paid in respect of that income. For the purposes of this deduction, the foreign tax paid by a taxpayer is the aggregate of the foreign tax which has been paid by him in respect of businesses carried on by him in foreign countries and two-thirds of the foreign tax paid by him in respect of foreign-source non-business income. This takes into account the fact that, while the provinces provide a foreign tax credit in respect of non-business income, they do not provide a credit for foreign tax on business income which is generally not subject to provincial tax. The example below illustrates the computation of the special foreign tax credit. It assumes that one-half of the taxpayer's income is from foreign sources and $500 of foreign tax has been paid on this foreign income.

Example

	Regular Tax	Minimum Tax
Basic federal tax	700	900
Less: Foreign tax credit — regular	350	—
— special	—	450
Net federal tax	350	450

Note: The AMT carryover of additional tax under section 120.2 without the foreign tax credit of $200 (900-700) will be reduced by $100 which reflects the increase in the foreign tax credit to which the taxpayer is entitled.

Section 127.55 provides that the minimum tax is not applicable to the special returns of income filed on behalf of bankrupt or deceased taxpayers nor to a taxation year in which a farmer or fisherman has elected to take advantage of the special block averaging provisions under section 119 of the Act.

Refundable Dividend Tax on Hand

Clause 49

Section 129 of the Act provides the mechanism under which a portion of the taxes paid by a private corporation in respect of its investment income (the portion referred to as "refundable dividend tax on hand") is refundable to the corporation when dividends are paid. This refundable tax mechanism provides what is generally referred to as "integration" for investment income, and seeks to ensure that the total tax paid on investment income and capital gains earned through a Canadian-controlled private corporation and distributed to an individual shareholder approximates the tax that would, but for the capital gains exemption, have been payable if the income were received directly by the individual. Because individual shareholders are entitled to claim a dividend tax credit representing tax already paid on income at the corporate level, the refundable tax consists of only the portion of corporate tax exceeding the tax represented by the credit.

The reduction in the dividend tax credit, consequential on the amendment to paragraph 82(1)(b) of the Act, requires certain amendments to be made to section 129 in order to maintain this integration of the investment income of private corporations.

Subclause 49(1)

ITA
129(1)(a)(i)

Existing subsection 129(1) of the Act permits certain corporations to claim a refund of their "refundable dividend tax on hand" for a taxation year equal to $1 for every $4 of taxable dividends paid by them in the year. The amendment to subparagraph 129(1)(a)(i) provides that the dividend refund available under subsection 129(1) will be at a rate of $1 for every $3 of taxable dividends paid by the corporation in the year, effective for taxable dividends paid after 1986. This change is consequential on the reduction of the gross-up in respect of such dividends to one-third from one-half of the amount of the dividend.

Subclause 49(2)

ITA
129(3)(a)

Subsection 129(3) of the Act defines the "refundable dividend tax on hand" of a private corporation. The amount added to the refundable dividend tax on hand of a Canadian-controlled private corporation in respect of the tax payable under Part I of the Act for a taxation year on its net investment income is equal to two-thirds of the least of the amounts determined under subparagraphs 129(3)(a)(i) to (iv) for the year. The reduction in the rate of the dividend tax credit requires the refundable portion of tax payable for a taxation year on the investment income of Canadian-controlled private corporations to be increased in order to preserve the so-called integration of tax paid on this income by the corporation and its shareholders. The amendment to paragraph 129(3)(a) provides that, effective for taxation years beginning after 1986, the annual addition to refundable dividend tax on hand is computed as an amount that is equal to – rather than two-thirds of – the least of the amounts described in subparagraphs 129(3)(a)(i) to (iv) of the Act.

Subclause 49(3)

ITA
129(3)(a)(iv)

The new 3-per-cent corporate surtax in section 123.2 of the Act, effective January 1, 1987, is not applicable to that portion of tax payable by a corporation that is included in its refundable dividend tax on hand. Consequently, the amendment to subparagraph 129(3)(a)(iv) ensures that the corporate surtax is not eligible to be included as part of the tax that may be ultimately refunded to the corporation under section 129. This amendment is applicable to the 1987 and subsequent taxation years.

Subclause 49(4)

ITA
129(3)(b.1)

The refundable portion of the tax payable on the investment income of a corporation is determined by the rate of dividend tax credit provided by the Act. Where a corporation has accumulated refundable dividend tax on hand in respect of investment income earned in taxation years beginning before 1987, the reduction in the dividend tax credit, applicable to taxable dividends received after 1986, requires that the corporation be entitled to a larger refund in order to preserve the integration of corporate and individual tax on this income. Provision for a larger refund is made in this amendment to subsection 129(3) of the Act and is achieved by increasing the refundable dividend tax on hand of the corporation at December 31, 1986 by the amount determined under subsection 129(3.3).

Subclause 49(5)

ITA
129(3.3) and (3.4)

New subsection 129(3.3) of the Act defines a corporation's "addition at December 31, 1986 of refundable dividend tax on hand" for the purposes of computing its refundable dividend tax on hand under subsection 129(3) of the Act. The addition is equal to one-half of the amount by which the corporation's refundable dividend tax on hand at the end of its last taxation year beginning before 1987 exceeds any Part IV tax payable by the corporation on dividends received in the year and after 1986 and one-quarter of any taxable dividends paid by the corporation in the year and before 1987. This new subsection is applicable to the 1987 and subsequent taxation years.

New subsection 129(3.4) of the Act is an anti-avoidance measure the purpose of which is to prevent a corporation from artificially increasing the amount of its refundable dividend tax on hand (RDTOH) eligible under new subsection 129(3.3) for the 50-per-cent "addition at December 31, 1986 of refundable dividend tax on hand". As noted above, this special addition to RDTOH seeks to maintain the integration of corporate and individual tax on the investment income of Canadian-controlled private corporations. Without an anti-avoidance provision, however, it would be possible for subsection 129(3.3) to be used to achieve an inappropriate result. For example, a private corporation could subscribe for shares of an unconnected corporation having a nominal paid-up capital. If the shares were redeemed before 1987 the private corporation would be subject to the 25-per-cent Part IV tax on a deemed dividend equal to the amount by which the redemption proceeds exceeded the paid-up capital of the shares. Upon payment after 1986 of a dividend to a shareholder who is neither an individual subject to tax on the dividend under Part I of the Act nor a corporation subject to the Part IV tax, the private corporation would be entitled to a dividend refund of 150 per cent of the Part IV tax actually paid by it with no offsetting tax liability in the hands of the recipient. A similar result would occur where as part of the same series of transactions the dividend was paid to another private corporation subject to Part IV tax which, in turn, distributed the dividend to a shareholder not subject to an offsetting tax liability.

New subsection 129(3.4), therefore, denies the 50-per-cent addition to a corporation's RDTOH in respect of Part IV tax payable on a dividend where the following circumstances exist:

> the corporation received the dividend after February 25, 1986 and before 1987;
>
> the dividend was received as part of a transaction or series of transactions effected after February 25, 1987; and
>
> one of the main purposes of the transaction(s) was to increase the corporation's RDTOH by virtue of the "addition at December 31, 1986 of refundable dividend tax on hand".

Subclauses 49(6) to (9)

These set out the effective dates for the amendments to section 129 of the Act.

Investment Corporations

Clause 50

Subclause 50(1)

ITA
130(1)

An investment corporation is permitted to deduct from the tax otherwise payable on its taxable income, other than its taxed capital gains, an amount which is intended to provide a net tax liability on that income that matches the rate of dividend tax credit available to its individual shareholders. This special deduction recognizes that investment corporations are required to distribute substantially all of their income, other than net taxable capital gains, to shareholders in the taxation year in which it is earned.

The reduction in the dividend tax credit, effective January 1, 1987, requires that this special deduction for investment corporations be correspondingly increased. Subsection 130(1) is amended to provide that the deduction from tax otherwise payable by an investment corporation will be increased from 16⅔ per cent to 22 per cent of the amount by which the corporation's taxable income exceeds its taxed capital gains. This amendment to subsection 130(1) also takes into account the reduction in the basic federal corporate tax rate under amended paragraph 123(1)(a).

This amendment is applicable to the 1987 and subsequent taxation years. However, a transitional rule described below applies where a corporation's taxation year overlaps the 1986 and 1987 calendar years.

Subclause 50(2)

This sets out the effective date for the amendment to subsection 130(1) of the Act, and contains two transitional provisions. The first reduces the deduction under that subsection for the portion of a corporation's taxation year that is before 1987, and the second increases the deduction for the period before July 1, 1989 when the basic corporation tax rate reduction under amended paragraph 123(1)(a) of the Act is fully implemented.

Mutual Fund Corporations

Clause 51

Subclause 51(1)

ITA
131(5)

Subsection 131(5) of the Act provides that a mutual fund corporation is considered to be a private corporation for certain purposes of the Act, one of which enables it to claim a refund under section 129 of Part IV tax paid in respect of its dividend income. Where a mutual fund corporation has accumulated refundable dividend tax on hand in respect of Part IV tax on dividends received in taxation years beginning before 1987, the reduction in the dividend tax credit requires that the corporation be entitled to a larger refund in order to preserve the integration of corporate and individual tax on this income. Provision for a larger refund is made by the special addition provided in new subsection 129(3.3) and this amendment to subsection 131(5) picks up this special addition.

This amendment is applicable to the 1987 and subsequent taxation years.

Subclause 51(2)

ITA
131(6)(d)(i)(C)

The new 3-per-cent corporate surtax in section 123.2, effective January 1, 1987, is not applicable to that portion of tax payable by an investment corporation or a mutual fund corporation that is included in its refundable capital gains tax on hand for the year. Consequently, clause 131(6)(d)(i)(C) is amended for the 1987 and subsequent taxation years to ensure that the corporate surtax is not eligible to be included as part of the tax that may be refunded to the corporation under section 131.

Subclause 51(3)

This sets out the effective date for the amendments to section 131 of the Act.

Cooperative Corporations

Clause 52

ITA
136(1)

Sections 135 and 136 of the Act contain special rules which apply to cooperative corporations. Subsection 136(1) provides that a cooperative corporation is not to be considered to be a private corporation except for certain purposes

of the Act. The amendment to this provision ensures that a taxpayer's capital losses arising on a disposition of shares or debt of cooperative corporations that are Canadian-controlled private corporations and that otherwise satisfy the definition of "small business corporation" in subsection 248(1) will qualify as business investment losses as determined under paragraph 39(1)(c). As such, one-half of the loss is deductible without restriction in calculating the taxpayer's income. This amendment is effective with respect to losses on dispositions after 1985.

Clause 53

Section 137 of the Act contains special rules relating to credit unions. Subsection 137(7) provides that a credit union is not to be considered a private corporation except for certain purposes of the Act. The amendment to this provision ensures that a taxpayer's capital losses arising on a disposition of shares or debt of credit unions that are Canadian-controlled private corporations and that otherwise satisfy the definition of "small business corporation" in subsection 248(1) will qualify as business investment losses as determined under paragraph 39(1)(c). As such, one-half of the loss is deductible without rectriction in calculating the taxpayer's income. This amendment is effective with respect to losses on dispositions after 1985.

Registered Retirement Savings Plans

Clause 54

ITA 146

Section 146 of the Act deals with registered retirement savings plans (RRSPs). This section is being amended in a number of important respects – to allow for the maturity of an RRSP at any time before the end of the year in which the annuitant becomes 71, to remove the prohibition against commutation of an annuity under an RRSP, to allow a payment to the annuitant before maturity and to increase the maximum deduction for contributions to an RRSP to $7,500 but not exceeding 20 per cent of earned income. These amendments are applicable to the 1986 and subsequent taxation years.

Subclause 54(1)

ITA 146(2)

Subsection 146(2) of the Act sets out the conditions that must be satisfied to register a retirement savings plan. The amendment to paragraph 146(2)(a) removes the prohibition against partial withdrawals from an RRSP before it matures. Paragraphs 146(2)(b), (b.1) and (c) allow for the commutation in whole or in part of an annuity payable under an RRSP after the plan matures. Paragraph 146(2)(b.4) allows an RRSP to mature and annuity payments to commence at any time before the end of the year in which the annuitant becomes 71 years of age. This removes the existing prohibition against commencing annuity payments under an RRSP before the annuitant becomes 60 years of age. The remaining paragraphs in subsection 146(2) retain most of the conditions reflected under the existing provisions, includ-

ing the requirement to mature an RRSP by the end of the year in which the annuitant becomes 71 years of age and the requirment that, except as expressly provided in existing subsection 146(3), an annuity must be payable in equal annual or more frequent periodic payments.

The amendments to subsection 146(2) are applicable to the 1986 and subsequent taxation years.

Subclause 54(2)

ITA
146(3)(c)

Paragraph 146(3)(c) of the Act provides for the commutation of relatively small annuities payable under an RRSP. This paragraph is repealed for the 1986 and subsequent taxation years as a result of the amendment to subsection 146(2) which permits the whole or partial commutation of any annuity under an RRSP.

Subclause 54(3)

ITA
146(5)(b)

Subsection 146(5) of the Act sets out the rules governing the deductibility of premiums payable by an annuitant under his RRSP. The amendment to paragraph 146(5)(b) increases the maximum deduction that may be claimed in 1986 and subsequent years by $2,000 so that it is now $7,500 or 20 per cent of the annuitant's earned income for the year, whichever is the lesser.

Subclauses 54(4) and (5)

ITA
146(8.3) to (8.7)

Under section 146 of the Act a taxpayer may make a deductible contribution to his spouse's RRSP. Subsection 146(8.3) is an anti-avoidance rule designed to discourage income-splitting as between spouses through the use of a spousal RRSP. The existing rules require an annuitant's spouse to include in income any benefit received in a year by the annuitant out of an RRSP to the extent that the spouse has made a contribution to a spousal RRSP that was deductible to the spouse under subsection 146(5.1) in that year or in the preceding two years. This subsection is amended as a result of the elimination of age 60 as the minimum earliest maturity date of an RRSP, coupled with the removal of the prohibition against commutations.

As amended, subsection 146(8.3) extends this rule to any commutation payment received by the taxpayer's spouse out of a spousal RRSP within three years from that in which the taxpayer made a contribution to the spousal RRSP. This rule does not apply where, at the time of the commutation payment, the taxpayer and his spouse were living separate and apart by reason of a marriage breakdown. Further, the rule does not apply to commutation payments received from a spousal RRSP that are applied as provided in amended paragraph 60(1).

New subsection 146(8.4) is consequential on the amendment to subsection 146(8.3) and permits the tracking of RRSP funds through successive RRSPs

or registered retirement income funds (RRIFs). Thus, an RRSP that receives property from a spousal RRSP to which the annuitant's spouse paid deductible premiums under subsection 146(5.1) is treated as an RRSP described in that provision.

New subsection 146(8.5) provides an ordering rule for the purpose of determining the particular premium paid to a spousal RRSP that is required by subsection 146(8.3) to be included in computing the contributor's income. The amendments to this provision simply make the wording conform to that in subsection 146(8.3) as amended.

New subsection 146(8.6) provides that, to the extent that any premium paid to a spousal RRSP by the annuitant's spouse is required by subsection 146(8.3) or new subsection 146.3(5.1) to be included in computing the income of the spouse at any time, that premium is considered not to be a premium paid by him in respect of any subsequent application of subsection 146(8.3). Further, this provision avoids double taxation by allowing the annuitant a corresponding deduction for amounts included in his spouse's income.

Subsection 146(8.7) is amended to provide that subsection 146(8.3) does not apply where the annuitant under a spousal RRSP or RRIF receives a commutation payment therefrom and in respect of which the annuitant claims a deduction under paragraph 60(1) as amended. Thus, for example, subsection 146(8.3) will not apply where the annuitant receives a commutation payment in the year from a spousal RRSP and claims a deduction in respect of the transfer of such payment to another RRSP. For this exception to apply, however, where the commutation payment is used to purchase an annuity as provided in paragraph 60(1) as amended, the annuity cannot be commuted in whole or in part within three years of its purchase.

These amendments are applicable to the 1986 and subsequent taxation years.

Subclause 54(6)

ITA
146(12)

Subsection 146(12) of the Act provides for an income inclusion where an RRSP is revised or amended and no longer complies with the requirements of section 146. The annuitant must include in his income an amount equal to the fair market value of all the property of the plan minus any amount required to be included in the income of the annuitant's spouse under subsection 146(8.3). The amendment to this provision allows an RRSP to be revised to provide for the commutation in whole or in part of any annuity payable under the plan and deletes a reference to subsection 146(8.3) as a consequence of the amendment to that provision.

This amendment is applicable for the 1986 and subsequent taxation years.

Subclause 54(7)

ITA
146(16) to (19)

Subsection 146(16) of the Act allows an annuitant to transfer the funds in his RRSP to another RRSP, registered pension plan or registered retirement income fund (RRIF). The amendment to this subsection permits a transfer from a taxpayer's RRSP to a RRIF of his spouse or former spouse pursuant to a written separation agreement or court order on a marriage breakdown. It also is amended to remove the requirement that an annuitant be at least 60 years of age before being allowed to transfer RRSP funds to a RRIF. This change is applicable to the 1986 and subsequent taxation years and is consequential on the amendments to section 146.3 relating to registered retirement income funds.

Subsection 146(17) of the Act is amended for the 1986 and subsequent taxation years strictly as a consequence of the amendments to subsection 146(2).

The repeal of subsection 146(18) of the Act for the 1986 and subsequent taxation years is consequential on other amendments to the provisions relating to registered retirement savings plans.

Subsection 146(19) of the Act is a transitional provision that is no longer applicable so it is repealed for the 1986 and subsequent taxation years.

Subclause 54(8)

This provides that the amendments to section 146 relating to registered retirement savings plans are applicable to the 1986 and subsequent taxation years.

Registered Retirement Income Funds

Clause 55

Section 146.3 of the Act provides the rules for registered retirement income funds (RRIFs). Significant amendments are made to this section: to permit a taxpayer to have more than one RRIF, to permit withdrawals from a RRIF in a year in excess of a minimum amount, to permit RRIFs to be commuted and to allow for the transfer of RRSP annuity commutations to a RRIF. The amendments are applicable to any RRIF established after February 1986 and to one established before March 1986 and amended after February 1986 for the taxation year in which it was amended and subsequent taxation years.

Subclause 55(1)

ITA
146.3(1)(b.1)

New paragraph 146.3(1)(b.1) of the Act defines the minimum amount that is required to be paid out of a RRIF to the annuitant each year. Payments in excess of the minimum amount for the year may be made to the annuitant as a consequence of an amendment to paragraph 146.3(1)(f). The minimum

amount of a RRIF for a year is calculated by dividing the value of the RRIF at the beginning of the year by a number that equals 90 minus the age of the annuitant (or his spouse where he elects) at that time. For example, where the RRIF's value at the beginning of the year is $30,000 and the annuitant is 70 at that time, the minimum amount for the year is $1,500. This amendment is applicable to any RRIF established after February 1986 and to any RRIF established before March 1986 and amended after February 1986.

Subclause 55(2)

ITA
146.3(1)(c)

Paragraph 146.3(1)(c) of the Act provides a definition of "property held" in connection with a retirement income fund. The amendment to this paragraph is consequential on the amendment to paragraph 146.3(1)(f) which permits payments to an annuitant from his RRIF in a year in excess of the minimum amount for the year. This amendment is applicable to any RRIF established after February 1986 and to any RRIF established before March 1986 and amended after February 1986.

Subclause 55(3)

ITA
146.3(1)(f)

Paragraph 146.3(1)(f) of the Act provides the definition of "retirement income fund". This paragraph is amended to require payments out of the RRIF in a year equal to the minimum amount for the year as determined under new paragraph 146.3(1)(b.1) and to permit payments in the year in excess of the minimum amount. The amendment to paragraph 146.3(1)(f) is applicable to any RRIF established after February 1986 and to any RRIF establish before March 1986 and amended after February 1986.

Subclause 55(4)

ITA
146.3(2)

Subsection 146.3(2) of the Act sets out the conditions that must be satisfied to register a retirement income fund. Paragraph 146.3(2)(a) describes the payments that may be made out of a RRIF. Paragraph 146.3(2)(b) allows the commutation in whole or in part of a RRIF. Existing paragraph 146.3(2)(c) which limits an annuitant to one RRIF is removed. Paragraph 146.3(2)(f) allows a RRIF to receive property from an individual in respect of an amount he has deducted under paragraph 60(1) as amended. A RRIF is also permitted to receive property from an RRSP or RRIF of the annuitant's spouse pursuant to a written separation agreement or court order arising out of a marriage breakdown. The remaining paragraphs of section 146.3(2) retain existing registration requirements.

This amendment to subsection 146.3(2) is applicable to any RRIF established after February 1986 and to any RRIF established before March 1986 that is amended after February 1986.

Subclause 55(5)

ITA
146.3(5.1) to (5.5)

Under subsection 146(5.1) of the Act, a taxpayer may make a deductible contribution to his spouse's RRSP. As a consequence of this subsection and the change to permit unlimited withdrawals from a RRIF, new subsection 146.3(5.1) is introduced. This is an anti-avoidance provision designed to discourage income-splitting as between spouses through the use of a spousal RRSP. This provision is similar to subsection 146(8.3) as amended and reference may be made to the commentary to that provision.

New subsection 146.3(5.1) requires an annuitant's spouse to include in income any amount received in a year by the annuitant out of a RRIF that exceeds the minimum amount for the year to the extent that the spouse has paid a premium in the year to a spousal RRSP that was deductible under subsection 146(5.1) and the RRIF had received transfers from a spousal RRSP. This rule does not apply where, at the time the amount is received by the annuitant from the RRIF, the annuitant and spouse were living separate and apart by reason of a marriage breakdown. In addition, it does not apply where the spouse has died in the year the amount is received or to the extent the annuitant has claimed a deduction under paragraph 60(1) in respect of the amount received.

New subsection 146.3(5.2) is consequential on the introduction of new subsection 146.3(5.1) and permits the tracking of spousal RRSP funds through successive RRIFs for the purposes of that provision. Thus, where an annuitant's RRIF that received property from a spousal RRSP to which the annuitant's spouse paid a deductible premium under subsection 146(5.1) transfers any property to another RRIF of the annuitant, the recipient RRIF is treated as a RRIF described in new subsection 146.3(5.1).

New subsection 146.3(5.3) provides an ordering rule for the purposes of determining the particular premium paid to a spousal RRSP that is required by new subsection 146.3(5.1) to be included in computing the contributor's income.

New subsection 146.3(5.4) provides that to the extent any premium is required by new subsection 146.3(5.1) or new subsection 146(8.3) to be included in computing the contributor's income at any time, that premium is considered not to have been deducted under subsection 146(5.1) for any subsequent application of that provision. The provision also provides a deduction to the annuitant for amounts received by him out of a RRIF to the extent that amount is required by new subsection 146.3(5.1) to be included in the income of the annuitant's spouse.

New subsection 146.3(5.5) is consequential on the introduction of new subsection 146.3(5.1) which requires certain payments received by a taxpayer's spouse out of a RRIF to be included in computing the taxpayer's income. This new subsection provides that new subsection 146.3(5.1) does not apply

in a year in which the taxpayer dies, at a time when the taxpayer or his spouse are no longer resident in Canada or to the extent the taxpayer's spouse has claimed a deduction under paragraph 60(1) as amended in respect of the payment received. In this latter case, however, the exception does not apply where the deduction is in respect of an annuity unless the annuity cannot be commuted in whole or in part within three years of its purchase.

These new subsections are applicable to any RRIF established after February 1986 and for any RRIF established before March 1986 and amended after February 1986.

Subclause 55(6)

ITA
146.3(11) to (14)

The repeal of subsections 146.3(11) to (14) of the Act is consequential on the amendments relating to RRIFs. New subsections 146.3(11), (12) and (13) are introduced and these provisions continue to deal with revocation of registration of RRIFs.

For example, new subsection 146.3(11) sets out rules governing the revocation of registration of a RRIF. This new provision generally authorizes the Minister of National Revenue to revoke registration where a RRIF is revised or amended and, as a result, no longer complies with the requirements applicable to RRIFs. An exception is made where the RRIF is amended to permit withdrawals in a year in excess of the minimum amount for the year.

New subsection 146.3(14) continues to deal with permitted RRIF transfers. However, it will now permit the transfer from one RRIF of an annuitant to another. Further, it will allow a transfer from the RRIF of an annuitant to an RRSP or RRIF of his spouse or former spouse under a written separation agreement or a court order arising out of a marriage breakdown.

These amendments are applicable to any RRIF established after February 1986 and to any RRIF established before March 1986 and revised after February 1986.

Subclause 55(7)

This provides that the amendments to section 146.3 relating to RRIFs are applicable to any RRIF established after February 1986 and to any RRIF established before March 1986 and amended after February 1986. In the latter case the amendments are applicable for the taxation year in which the change is made and subsequent taxation years.

Returns

Clause 56

ITA
150(1)

Section 150 of the Act sets out the requirements relating to the filing of tax returns. Subsection (1) thereof, which sets out the filing dates for the tax returns of different categories of taxpayers, is amended to provide that an individual who has received a prepayment of the child tax credit is required to file a return for the taxation year in which he received the payment, whether or not he has a tax payable for that year. This amendment, which is consequential on the introduction of the provisions in section 164.1 of the Act relating to the prepayment of the child tax credit, is applicable to the 1986 and subsequent taxation years.

Assessment

Clause 57

ITA
152(1.1) to (1.3)

Subsections 152(1.1) to (1.3) of the Act set out rules which apply where the Minister of National Revenue does not agree with the amount reported by a taxpayer as his non-capital loss, net capital loss or restricted farm loss. The Minister is required, at the taxpayer's request, to make a determination of the amount of the loss. Any such determination is subject to the taxpayer's rights of objection and appeal. The amendments to subsections 152(1.1) to (1.3) are consequential on the introduction of the new provisions relating to limited partnership losses. After February 25, 1986 the rules relating to loss determinations are extended to limited partnership losses as defined in new subsection 96(2.1).

Tax Instalments of Farmers and Fishermen

Clause 58

ITA
155

Section 155 of the Act provides a special rule for the instalment obligations of individuals whose principal source of income is farming or fishing. Generally, such persons are required to make only one tax instalment at the end of each year. This payment is two-thirds of the lesser of the individual's instalment base for the preceding year and his estimated tax for the year. The amendment to paragraph 155(1)(a) excludes from this estimate the additional taxes resulting from the application of the provisions relating to the minimum tax. This amendment is applicable only to the 1986 taxation year. For 1987 and subsequent taxation years, the additional tax resulting from the provisions relating to the minimum tax will be required to be taken into account in determining the required tax instalments.

Tax Instalments of Individuals

Clause 59

ITA
156

Section 156 of the Act contains the general rules for determining the tax instalments required of most individuals. Paragraph 156(1)(a) sets out the formula for determining the required instalments for a taxation year. The

amendment to this paragraph provides that the additional taxes payable as a result of the introduction of the minimum tax may be ignored in calculating the required instalments for the 1986 taxation year. For the 1987 and subsequent taxation years, the additional tax resulting from the provisions relating to the minimum tax will be required to be taken into account in determining the required tax instalments.

Refund of Excess Amount

Clause 60

Subclause 60(1)

ITA
160.1(1)

Subsection 160.1(1) of the Act provides that where an amount refunded to a taxpayer under the circumstances described in that subsection is greater than the refund to which the taxpayer was entitled, the taxpayer is required to repay the excess in addition to any interest computed from the date the excess amount was paid to the taxpayer. Subsection 160.1(1) is amended for the 1986 and subsequent taxation years to include a reference to the provisions relating to the new refundable federal sales tax credit and the prepayment of the child tax credit.

Subclause 60(2)

ITA
160.1(2), (2.1) and (3)

Subsection 160.1(2) of the Act provides that the recipient of a child tax credit and the person supporting the child from whom the credit was claimed are jointly and severally liable to repay any excess credit paid to the recipient. This subsection is extended for the 1986 and subsequent taxation years to apply to prepayments of the child tax credit.

New subsection 160.1(2.1) of the Act provides that an individual who claims the refundable federal sales tax credit and his spouse with whom he filed a prescribed form claiming the credit are jointly and severally liable to repay any excess credit that was previously paid to the individual. This provision is applicable to the 1986 and subsequent taxation years.

The amendment to subsection 160.1(3) of the Act is strictly consequential on the introduction of new subsection 160.1(2.1) and is applicable to the 1986 and subsequent taxation years.

Subclause 60(3)

This provides the effective date for the amendments to section 160.1 of the Act.

Penalties

Clause 61

Subclause 61(1)

ITA
163(2)

Any taxpayer who, knowingly or under circumstances amounting to gross negligence, makes a false statement or omission in a return is liable to a penalty under subsection 163(2) of the Act of 25 per cent of the amount of additional tax that is attributable to the omission or false statement. This subsection is amended by the addition, for the 1986 and subsequent taxation years, of new paragraph (b.1) which allows the 25-per-cent penalty to be imposed where a false statement or an omission is made in respect of the new refundable federal sales tax credit provided in section 122.4 of the Act.

Subclause 61(2)

ITA
163(2.2)

New subsection 163(2.2) of the Act provides a penalty where a taxpayer makes a false statement or omission in a renunciation of resource expenses under subsections 66(10) to (10.3) and new subsections 66(12.6), (12.62), (12.64) and (12.66) of the Act. The penalty is 25 per cent of the amount of resource expenses purported to be renounced in excess of the amount that the taxpayer was entitled to renounce as of the effective date of the renunciation.

Subclause 61(3)

This sets out the effective date for the amendment to subsection 163(2) of the Act.

Prepayment of the Child Tax Credit

Clause 62

ITA
164.1

The Act is amended by the introduction of new section 164.1 which provides for a prepayment of a portion of the child tax credit for the 1986 and subsequent taxation years. Under subsection 164.1(1), the prepayment will be made to an individual for a particular taxation year in respect of an eligible child where the child was under 17 years of age at the end of the preceding year and the family income for that year was equal to or less than $15,000. The amount to be prepaid for any year is to be prescribed in the *Income Tax Regulations* and for 1986 is $300 for each eligible child of the individual and is to be paid in November 1986. The prepayment is on account of the child tax credit (maximum $454 per child for 1986) to which the individual is entitled. Subsection 164.1(3) provides that any prepayment in excess of the amount of the credit to which an individual is entitled will be recovered by

being applied against any tax refund claimed by the individual or added to his balance of tax payable. The recovery does not apply, however, in the case of a deceased child who would have been eligible for the purposes of the credit.

Surtax on Individuals

Clause 63

ITA
180.1

Section 180.1 of the Act is amended to reflect the introduction of a new surtax on individuals. For years after 1986, the surtax will be 3 per cent of an individual's tax otherwise payable under Part I of the Act for the year. For 1986, the rate of the new surtax will be 1½ per cent of the amount of tax otherwise payable for the year including the existing surtaxes of 5 per cent and 10 per cent depending on the taxpayer's tax liability. The new surtax will be calculated by reference to the tax payable under Part I. For this purpose "tax payable under Part I" is defined in subsection 180.1(2) as the tax payable before any deduction in respect of the overseas employment tax credit, the foreign and investment tax credits and the share purchase, scientific research and labour-sponsored funds tax credits and before the special addition provided in subsection 120(1) in respect of income not earned in a province.

New subsection 180.1(1.1) provides a deduction in respect of any additional foreign tax credit to which a taxpayer would be entitled if the foreign tax credit limitation were calculated by reference to the aggregate of his tax otherwise payable under Part I and his surtax as determined under subsection 180.1(1).

Mutual fund trusts will not be required to pay the surtax on taxed capital gains for the year.

Corporate Distributions Tax

Clauses 64 and 65

ITA
181(1)(a)

Clause 64

Part II of the Act imposes a 12½-per-cent tax on the dividends distributed from a corporation's income which has qualified under subsection 125(1) of the Act for the small business deduction. This tax when added to the federal and provincial taxes payable by the corporation on such income approximates the dividend tax credit provided to individual shareholders on the dividend. With the reduction in the dividend tax credit, effective for dividends received after 1986, the corporate distributions tax is no longer appropriate. The amendment to paragraph 181(1)(a) provides that the corporate distributions tax will cease to apply to taxable dividends paid after 1986.

ITA
Part II

Clause 65

The corporate distributions tax under Part II of the Act has been rendered unnecessary by the reduction of the dividend tax credit, effective January 1, 1987, as provided in the amendment to paragraph 82(1)(b). Accordingly, this subclause repeals Part II of the Act with respect to taxes payable under that Part for taxation years beginning after 1986.

Part III Tax – Excessive Capital Dividend Elections

Clause 66

Subclause 66(1)

ITA
184(3.2)

Under subsection 83(2) of the Act, a corporation may elect to have the whole amount of a dividend that is payable by it to be treated as a capital dividend paid out of its capital dividend account. Where a corporation elects in respect of a dividend payable by it and that dividend exceeds its capital dividend account, subsection 184(2) requires the corporation to pay a special tax equal to three-quarters of the amount of the excess. New subsection 184(3.2) provides relief from this tax on excessive elections where it can be shown that the corporation made a reasonable attempt to correctly ascertain its capital dividend account immediately before the dividend became payable. This relief is available only in respect of excessive elections under subsection 83(2) on capital dividends payable after December 3, 1985 and before 1986 in anticipation of the minimum tax. Where the corporation elects under this new subsection in respect of an excess dividend, the excess will not be subject to the tax. In this case, the excess will be treated as a loan made by the corporation to the persons who received the dividend, provided the excess amount is repaid to the corporation before a date to be fixed by the Minister of National Revenue.

These new rules relating to excess capital dividends are effective on Royal Assent and are patterned on the existing provisions in section 184 which provides relief for excess dividends paid out of a corporation's tax-paid undistributed surplus or its 1971 capital surplus.

Subclause 66(2)

ITA
184(4) and (5)

The amendments to subsections 184(4) and (5) of the Act, effective on Royal Assent, are consequential on the introduction of new subsection 184(3.2) relating to excess capital dividends. These subsections are amended to add a reference to that new subsection. Subsection 184(4) provides that an election under new subsection 184(3.2) is valid only if it is made with the concurrence of the corporation and all the shareholders entitled to receive the capital dividend in respect of which an election was made. Subsection 184(5) provides for the payment of a penalty where a corporation has made an excessive election and has elected in respect of the excess dividend under new subsection 184(3.2).

Clause 67

The purpose of Part IV of the Act is to prevent the deferral of tax on portfolio dividend income through the use of a private or closely-held corporation. While dividends received by individuals will be subject to tax in their hands, corporations are generally permitted to deduct such amounts from their taxable income. In order to eliminate the incentive for individuals to obtain a significant deferral of tax on their dividend income by transferring their portfolio shareholdings to a private corporation, Part IV imposes a 25-per-cent tax on dividends received by such corporations which is intended to approximate the tax that would be paid by an individual taxable at the highest marginal tax rate had he received the dividends directly. This tax is fully refundable to the corporation, as a dividend refund, when its earnings are distributed to its shareholders, since the shareholders will then be subject to tax at their marginal rates on the distribution.

Subclause 67(1)

ITA
186(1)

Because of the reduction of the dividend tax credit provided to individuals in receipt of taxable dividends paid after 1986, the rate of tax imposed under Part IV is increased from 25 per cent to 33 ⅓ per cent for dividends received after 1986 to reflect the increase in the rate of tax payable by individuals on such dividends.

Subclause 67(2)

ITA
186(1)(b)(i)

Where a corporation which has paid the special tax under Part IV of the Act distributes dividends, it will be entitled to claim a refund of the special tax. Where the dividend is paid by a connected corporation, paragraph 186(1)(b) imposes a tax on the dividend in the hands of the shareholder corporation of an amount equal to the dividend refund in respect thereof obtained by the connected corporation.

An amendment to subsection 129(1) of the Act provides that the dividend refund rate on dividends paid after 1986 will increase to $1 for every $3 of dividends paid. The amendment to subparagraph 186(1)(b)(i) of the Act is consequential on the amendment to subsection 129(1) and provides that the 33 ⅓-per-cent tax under Part IV on dividends received from a connected corporation will apply to three times the appropriate portion of the dividend refund in respect thereof. This amendment is applicable to dividends received in the 1987 and subsequent taxation years. However, a transitional rule applies where a taxation year overlaps the 1986 and 1987 calendar years. In this case, Part IV tax is levied with respect to a dividend received in the year and before 1987 on the recipient's share of four times the payor's dividend refund.

ITA
186(5)

Subclause 67(3)

Subsection 186(5) of the Act provides that a subject corporation (as defined in subsection 186(1) of the Act) is considered to be a private corporation for certain purposes of the Act, one of which enables it to claim a dividend refund under section 129 of Part IV tax paid in respect of its dividend income. Where a subject corporation has accumulated refundable dividend tax on hand in respect of Part IV tax paid on dividends received before 1987, the reduction in the dividend tax credit requires that the corporation be entitled to a larger refund in order to preserve the integration of corporate and individual tax on this income. Provision for a larger refund is made by the special addition provided in new subsection 129(3.3) and this amendment to subsection 186(5) picks up this special addition for subject corporations.

Subclause 67(4)

This sets out the effective date for the amendments to subsection 186(1) of the Act and contains a transitional provision for those corporations with a taxation year which overlaps the 1986 and 1987 calendar years.

Subclause 67(5)

This sets out the effective date for the amendment to subsection 186(5) of the Act.

Part XI – Tax on Foreign Property

ITA
206(1)(d.1)

Clause 68

Part XI of the Act (sections 205 to 207) provides that certain trusts and other tax-exempt persons governed by deferred income plans are subject to a special tax where more than 10 per cent of their property consists of foreign property. The definition of "foreign property" in subsection 206(1) is amended to include property described in new paragraph (d.1). Generally, this includes an interest in a Canadian corporation whose share value is derived primarily from portfolio investments in foreign property. The purpose of this amendment is to prevent the circumvention of the foreign property limit provided in Part XI through the use of one or more Canadian corporations to hold portfolio foreign investments. The amendment does not apply to shares of a Canadian corporation that are listed on a prescribed stock exchange in Canada, where the share belongs to a class no share of which was issued after December 4, 1985 otherwise than pursuant to an agreement in writing entered into before 5:00 p.m. EST on that date.

The amendment is applicable to shares and indebtedness acquired after December 4, 1985, except pursuant to an agreement in writing entered into before 5:00 p.m. EST on December 4, 1985 – the date on which the details of the proposed amendment were announced.

Tax on Carved-out Income

Clause 69

ITA
Part XII.1

New Part XII.1 of the Act imposes a special tax at the rate of 50 per cent on carved-out income earned by a taxpayer in a taxation year. This special tax is introduced to prevent the use of so-called carve-out arrangements as an after-tax financing technique. In a typical carve-out arrangement, a profitable resource company transfers a temporary interest in a producing oil or gas well (in industry terms, this event is described as the "carving-out" of income) to another corporation which has substantial accumulated losses or is a tax-exempt entity. After a period of time the resource properties would generally be reconveyed to the resource company. The result of a carve-out arrangement is that the income that would otherwise be taxable in the hands of the profitable resource company would escape tax because of the accumulated losses or the tax-exempt status of the purchaser. The new tax imposed under Part XII.1 is intended to remove the tax advantage of carve-out arrangements.

Where the income of a taxpayer is subject to the special tax under Part XII.1, new subsection 66(14.6) provides a deduction to the taxpayer under Part I of the Act equal to the amount of the carved-out income. This deduction ensures that the same income is not taxed both under the new Part and under Part I of the Act.

ITA
209(1) to 209(6)

New subsection 209(1) of the Act defines terms used in the provisions relating to carve-out arrangements, namely "carved-out income" and "carved-out property".

"carved-out income"

The special tax under the new Part is computed on the carved-out income of a taxpayer from a carved-out property. The definition of carved-out income specifically denies certain deductions in computing such income. For example, no deductions are allowed for interest or other expenses provided under section 20 other than the resource allowance under paragraph 20(1)(v.1). In addition no deduction is allowed under section 104 for payments to the beneficiaries of a trust. Furthermore, no deduction is allowed for the various exploration, development and other resource expenses under subdivision e (other than any Canadian oil and gas property expense or Canadian development expense in the case of tar sands properties) that are attributable to the carved-out property. Where a taxpayer receives carved-out income through a partnership, his share of the carved-out income of the partnership will be subject to the special tax.

"carved-out property"

In general terms, a carved-out property is defined as a Canadian resource property in which the taxpayer has a temporary interest. Essentially, a carved-out property means a Canadian resource property of a taxpayer in those circumstances where his right to receive royalties in respect of the property may reasonably be considered to be limited to a maximum amount or an amount determinable by reference to a stated quantity of production from a mineral resource or an accumulation of petroleum, natural gas or related

hydrocarbons. For example, a taxpayer will be treated as acquiring a carved-out property where his right to receive income from the property is limited to his receiving a maximum dollar amount or an amount that is limited to the income to be derived from a predetermined amount of production. Provided a significant portion of the taxpayer's income from the property is limited in this way, the existence of a provision in the agreement which allows the taxpayer to receive a variable amount which relates to some factor such as interest will not prevent the property from falling within the definition of carved-out property.

Subparagraph (a)(ii) of the definition of carved-out property deals with limited term leases. It provides that where a taxpayer acquires an interest in a sub-lease on a producing property for a term that is less than the remainder of the head lease to which the sub-lease relates, the sub-lease will be considered to be a carved-out property unless the term of the sub-lease was in excess of 10 years. Thus, in general, a sub-lease will be viewed as a carved-out property if its term is less than the term left to run in the head lease.

Subparagraph (a)(iii) of the definition of carved-out property treats a resource property, such as a sub-lease, as a carved-out property where the taxpayer's interest in the property, expressed as a percentage of production for any period, is substantially reduced at any time before the expiry of the term of the head lease. A sub-lease would not be considered to be a carved-out property where the reduction occurs after the expiry of a 10-year period commencing when the sub-lease was acquired. For example, a producing property transferred for five years, where the taxpayer is entitled to receive 5 per cent of production for the first two years and 0.1 per cent for the remaining three years, would fall within the definition.

Subparagraph (a)(iv) of the definition of carved-out property applies where a taxpayer acquires an interest in property that could be temporary because the original owner or any other person has an option to purchase the property and one of the main purposes of the option is to avoid taxes payable under the Act.

Paragraph (b) of the definition of carved-out property applies where a taxpayer attempts to circumvent these rules by using a partnership or a trust as the vehicle to hold the oil and gas property – for example, where the taxpayer has a right or obligation to sell his trust or partnership interest at a predetermined price. In this case, the taxpayer would be considered to have acquired a carved-out property and the income from the property flowed out to him through his partnership or trust interest would be treated as carved-out income subject to the special tax.

The definition provides that certain properties will not be regarded as carved-out properties. Paragraph (c) exempts what are generally referred to in the

industry as farm-out arrangements. Under a typical farm-out arrangement, a taxpayer earns his interest in the property solely in consideration of his obligation to incur Canadian exploration expense or Canadian development expense. A farm-out arrangement is generally entered into to explore for oil or gas and involves risk. Without this exemption, a farm-out arrangement could constitute a carved-out property by virtue of subparagraph (a)(iii) of the definition where, for example, the taxpayer's interest in the property fluctuates under a provision in the farm-out agreement which allows the taxpayer to receive 100 per cent of the production revenue until pay-out – that is, until the recovery of his expenses – and a lower percentage thereafter.

Paragraph (d) of the definition provides an exemption for what are referred to as retained royalties, which are often taken back by the vendor on the sale of a working interest in a Canadian resource property. A retained royalty arrangement is akin to an "earn-out" arrangement and is very often taken back when the value of a property is difficult to determine – for example, when the reserves in respect of an oil property cannot be determined.

Paragraphs (e) and (f) of the definition provide authority to the Minister of Finance to prescribe a property not to be a carved-out property. The *Income Tax Regulations* will exclude from the definition of carved-out properties Canadian resource properties that are interests in mining properties other than bituminous sands deposits, oil sands deposits or oil shale deposits. A draft version of the proposed Regulation is attached to these notes as Appendix II.

The definitions of "head lease" and "term" are self-explanatory and are relevant for the purposes of determining whether a taxpayer owns a carved-out property.

New subsection 209(2) of the Act requires a taxpayer to pay a special tax for a taxation year at the rate of 50 per cent on his carved-out income for the year. The income taxed under this provision is deductible under subsection 66(14.6) in computing the taxpayer's income that is subject to regular personal or corporate tax under Part I of the Act.

New subsection 209(3) of the Act requires a taxpayer liable to pay tax under new Part XII.1 to file a return under that Part by the date on which his regular tax return is required to be filed – generally April 30 in the case of individuals, six months after the end of its taxation year in the case of corporations, and 90 days after the year end in the case of estates and trusts. This subsection also requires a taxpayer to estimate his Part XII.1 tax liability on his return.

New subsection 209(4) of the Act relates to payments of the Part XII.1 tax. A taxpayer is required to pay monthly tax instalments in each year equal to 1/12 of the amount of the special taxes payable for the year and any remainder by the end of the second month following the end of the year.

New subsection 209(5) of the Act sets out the rules relating to interest on late or deficient payments, appeals and various other procedural and administrative matters with respect to the Part XII.1 tax.

New paragraph 209(6) of the Act treats a partnership as a person for the purposes of the definition of carved-out income in subsection 209(1). The new provisions relating to carved-out income will apply to any property acquired by a taxpayer after July 19, 1985. However, there are two exceptions to this rule. The first is for properties acquired after July 19, 1985 where such properties were acquired pursuant to an agreement in writing entered into before July 20, 1985. The second exception is for property acquired by a taxpayer pursuant to an agreement in writing entered into after July 19, 1985 where that agreement replaces an agreement that was concluded before July 20, 1985 but was rescinded or terminated. In this latter case the exception will apply only if the terms and conditions of the second agreement are substantially the same as those contained in the first agreement entered into before July 20, 1985. The coming-into-force provision also provides that where an agreement entered into before July 20, 1985 for the purchase of a Canadian resource property is materially altered in any way, the property shall be deemed to have been acquired on the date of the change. The changes to an agreement which render it off-side are described in paragraphs (c) to (g) of the coming-into-force provision.

Non-Resident Withholding Tax

Clause 70

Section 212 of the Act is the principal provision of the Act dealing with the 25-per-cent non-resident withholding tax. It enumerates the various payments to non-residents that are subject to this tax.

Subclause 70(1)

ITA 212(1)(b)(iii)(D)

Clause 212(1)(b)(iii)(D) of the Act provides that interest paid on arm's length foreign currency deposits with a bank is exempt from the non-resident withholding tax under section 212. This clause is amended by expanding the exemption to apply to interest paid after Royal Assent on such deposits with any prescribed financial institution. The amendment is not applicable to interest paid or credited on amounts deposited before 1988 with a bank to which the *Bank Act* applies.

Subclause 70(2)

ITA 212(1)(b)(vii)

Subparagraph 212(1)(b)(vii) of the Act provides an exemption from non-resident withholding tax for interest paid to an arm's length lender on a corporate debt obligation under which the issuer is not required to repay more

than 25 per cent of the principal within five years of the date of its issue. The result is that a loan agreement that permits a non-resident lender to convert a debt obligation into shares of the Canadian borrower before the expiration of the five-year period contravenes the requirements for the exemption. This amendment provides that interest paid after Royal Assent on corporate debt that would otherwise be eligible for the exemption will not be disqualified where the lender is permitted to convert the debt into a prescribed security within five years of issue of the debt.

Subclause 70(3)

ITA
212(1)(b)

Paragraph 212(1)(b) of the Act taxes all forms of interest paid or credited by a Canadian resident to a non-resident, subject to specific exemptions from the tax as set out in the subparagraphs thereof. New closing words in paragraph 212(1)(b) remove the exemptions contained in subparagraphs 212(1)(b)(ii) to (vii) and (ix) for interest payable on an obligation issued or extended after February 25, 1986 (otherwise than pursuant to an agreement made on or before that date) where all or part of the interest is computed by reference to revenue, profits, cash flow, commodity prices or any other similar criterion or by reference to dividend payments.

Subclause 70(4)

ITA
212(18)

New subsection 212(18) of the Act provides that financial institutions, prescribed for the purposes of the exemption from non-resident withholding tax for interest paid on arm's length foreign currency deposits provided by clause 212(1)(b)(iii)(D), will be required to file annual information returns six months after year-end and, where requested by the Minister of National Revenue, an undertaking in prescribed form relating to avoidance of Part XIII tax.

Subclauses 70(5) to (7)

These set out the effective date for the amendments to section 212 of the Act.

Investment Income Reporting

Clause 71

ITA
221(1)

Subsection 221(1) of the Act provides the statutory authority for the Governor in Council to make regulations. This subsection is amended by adding new paragraph 221(1)(d.1) to authorize the Governor in Council to make regulations requiring taxpayers to provide their names, addresses and social insurance numbers to certain persons (generally banks and brokers of or dealers in securities) from whom they have acquired a bearer debt obligation.

This amendment is required to give effect to the proposal announced in the February 1986 budget to require new information reporting, including the reporting of social insurance numbers, in respect of individuals trading in bearer instruments. This amendment comes into force on a day to be fixed by proclamation.

Offences

Clause 72

ITA
238(1)

Subsection 238(1) of the Act makes it an offence for a person to fail to file a return as and when required under the Act. The fine is not less than $25 for each day of default. This subsection is amended as a consequence of the introduction of new paragraph 221(1)(d.1) authorizing regulations to require taxpayers to provide certain information where they have acquired a bearer debt obligation. The amendment to subsection 238(1) ensures that a failure to comply with the new information requirements will be considered to be an offence under that subsection. This amendment comes into force on a day to be fixed by proclamation.

Communication of Information

Clause 73

ITA
241(4)(e)

Subsection 241(4) of the Act describes those circumstances under which an official or authorized person may communicate information obtained for the purposes of the Act. Paragraph 241(4)(e) authorizes the communication of information, received from a transferor of property relating to the cost or capital cost of the property, to the transferee of that property where, under any provision of the Act, that cost or capital cost is other than the purchase price of the property. This provision is amended, effective after February 25, 1986, to add a reference to a taxpayer's adjusted cost base. This new reference to adjusted cost base is consequential on the introduction of the new provisions relating to limited partners and, in particular, to the provisions in new subsection 96(2.3) relating to the at-risk amount in respect of the second and subsequent owners of a limited partnership interest.

Definitions

Clause 74

ITA
248

Section 248 of the Act defines many of the terms used in the Act.

Subclauses 74(1) to (3)

"employee benefit plan"

The definition of "employee benefit plan" is amended for the 1986 and subsequent taxation years to exclude a "salary deferral arrangement". This amendment is consequential on the addition of the provisions relating to salary deferral arrangements.

"small business corporation"

Subsection 248(1) of the Act defines a "small business corporation" as a Canadian-controlled private corporation that uses all or substantially all of its assets in an active business carried on in Canada. This definition is replaced by a new definition of that term, applicable after 1985. This new definition contains two main changes. The first provides that a "small business corporation" is a Canadian-controlled private corporation that uses all or substantially all of its assets in an active business carried on primarily in Canada. The second provides that, for the purposes of determining a taxpayer's business investment loss under paragraph 39(1)(c), a corporation will be considered to be a small business corporation if it was a small business corporation at any time in the 12 months immediately preceding the time the investor disposed of his investment in the corporation. As a result, investors will not be precluded from claiming an allowable business investment loss on the disposition of shares or debt of a small business corporation where it ceases to carry on an active business because it has become bankrupt or is being wound-up prior to the disposition.

"prescribed"

The definition of "prescribed" in subsection 248(1) of the Act is amended to clarify that it includes whatever may be determined in accordance with rules set out in the *Income Tax Regulations*. This will apply in determining, among other things, the amount deductible under new paragraph 110.7(a) and qualified Canadian expenditures referred to in subsection 127(9). This amendment is effective on Royal Assent.

"deferred amount"
"salary deferral arrangement"

The definitions of "deferred amount" and "salary deferral arrangement" are added to subsection 248(1) of the Act with respect to taxation years after 1985. These expressions are relevant to the new provisions, particularly those in subsections 6(11) to (14), relating to salary deferral arrangements.

Generally, a "salary deferral arrangement" is a plan or arrangement one of the main purposes of which is to permit a taxpayer to postpone tax in a taxation year in respect of salary or wages the receipt of which has been deferred to a subsequent year. This arrangement may be funded; hence an arrangement that would be an employee benefit plan under the existing rules may fall under the definition of a salary deferral arrangement. The arrangement may also be unfunded; for example, the deferred amount for one year may be payable by an employer to the employee in a subsequent year. The right to receive a deferred amount under a salary deferral arrangement in respect of a taxpayer need not be that the taxpayer. For example, it may be that of the spouse of the taxpayer or some other person.

The definition provides that where a person's receipt of a deferred amount is subject to one or more conditions, these conditions will be ignored for the purposes of the definition unless there is a substantial risk that the condition will not be satisfied. It is recognized that the expression "substantial risk" lacks precision and some general comments as to the appropriate interpretation of the definition of "salary deferral arrangement" may be useful.

It is important to emphasize that the proper interpretation of the definition in a specific case rests ultimately with the courts. Whether a particular condi-

tion results in a substantial risk of forfeiture can only be determined through a careful consideration of all the relevant facts and it is difficult to draw firm guidelines of general application. For these reasons, the comments which follow are necessarily general but serve to identify the intended application of the provision in certain cases.

As a general rule, a substantial risk of forfeiture would arise if the condition imposes a significant limitation or duty which requires a meaningful effort on the part of the employee to fulfill and creates a definite and substantial risk that forfeiture may occur.

It is intended that the following types of conditions would generally be ignored in determining whether plan or arrangement is a salary deferral arrangement:

- receipt of the deferred amount is contingent on the employee abstaining from competition or making himself available for advice and consultations following retirement or termination;
- receipt of the deferred amount is contingent on the employees refraining from transferring or encumbering his interest in the deferred amount;
- receipt of the deferred amount is contingent on the employee not being dismissed for cause or the commission of a crime; or
- receipt of the deferred amount is contingent on the employee remaining as an employee for a minimum period, say three years, unless there is definite and substantial risk that the employment may be terminated before that time in circumstances beyond the control of the employee.

A number of plans or arrangements are expressly excluded as salary deferral arrangements. These include arrangements that are excluded from the existing definition of employee benefit plan such as registered pension funds or plans or group sickness or accident insurance plans. In addition, there is an exclusion for plans or arrangements under which professional athletes defer salary or wages. It is intended that self-funded leave of absence arrangements established for teachers and other employees to provide for sabbaticals will also be excluded from the definition as prescribed plans.

Certain existing plans or arrangements are grandfathered from the definition. The definition of "salary deferral arrangement" does not apply to deferred amounts under certain plans or arrangements which were in existence on February 26, 1986. This grandfather treatment applies in the case of a salary deferral arrangement in respect of a taxpayer to the extent that the deferred amounts relate, or may reasonably be considered to relate, to services rendered by the taxpayer before April 1986. For example, an employee benefit plan would not be a salary deferral arrangement to the extent that all contributions to the plan were in respect of services rendered by the participating employees before April 1986.

Excluded also are plans or arrangements to the extent that the deferred amounts relate, or may reasonably be considered to relate, to services rendered after March 1986 and where both of the following conditions are met:

- the employer is legally obligated to defer payment of these amounts to the employee pursuant to an agreement in writing made with his employee or former employee before February 26, 1986; and
- the employee cannot, at any time after April 1986, cancel or otherwise avoid that obligation.

The result is that where the first condition is satisfied, grandfather treatment does not apply to a deferred amount after March 1986 that relates to services rendered after that date if, under the terms of the arrangement, the employee may take any action to cause the deferral not to occur. For example, if the deferral is to continue under the arrangement after April 1986 until the employee otherwise directs, deferred amounts after April are not eligible for grandfather treatment. The same result would apply if these deferrals continue but under the terms of the arrangement the employee can direct that the deferred amounts be nil.

Subsection 248(1) of the Act is also amended to add a definition of the term "deferred amount". This term is defined as an amount that a person has a right to receive in a subsequent taxation year under a salary deferral arrangement in respect of a taxpayer. However, in the case of a trust governed by a salary deferral arrangement in respect of a taxpayer, "deferred amount" is more restrictively defined as a right that a person has to receive an amount that has been or will be paid to the trust in respect of services rendered by the taxpayer.

"limited partnership loss"

The addition of the definition of "limited partnership loss" to subsection 248(1) of the Act is consequential on the introduction of the new rules in sections 96, 111 and 127 which restrict the deduction of losses and investment tax credits of limited partners. This amendment is applicable after February 25, 1986.

Subclause 74(4)

ITA
248(11)

The amendment to subsection 248(11) of the Act provides that interest paid on refunds and charged on late payments of taxes, interest and penalties provided for in other provisions of the Act will be compounded on a daily rather than a quarterly basis. Interest will not be compounded before the date of proclamation on which this amendment enters into force.

Subclauses 74(5) to (8)

These set out the effective date for the amendments to section 248.

Inducements and Reimbursements

ITA
12(1)(x)

Clause 75

Subsection 6(6) of Bill C-84 provided the effective date for paragraph 12(1)(x) of the Act. Paragraph 12(1)(x) relates to the treatment of certain leasehold inducements and other reimbursements. The amendment in this clause ensures that paragraph 12(1)(x) of the Act, as enacted in Bill C-84, will not be effective with respect to amounts received pursuant to the terms of an agreement in writing entered into before 4:30 p.m. EDT on May 23, 1985, rather than pursuant to such agreements entered into before May 23, 1985, as was originally proposed.

Business Investment Losses

ITA
39(1)(c)

Clause 76

Subparagraphs 39(1)(c)(iii) and (iv) of the Act were amended in Bill C-84, applicable to the 1986 and subsequent taxation years, to provide that a business investment loss of a taxpayer will arise on a disposition of a share or debt of a small business corporation rather than a Canadian-controlled private corporation. The change in the effective date of the amendments to those subparagraphs is relieving in nature and provides that they are applicable to dispositions made after 1985.

Deferred Profit Sharing Plans

ITA
110(1)(d.3)

Clause 77

Paragraph 110(1)(d.3) of the Act was added by Bill C-84 to provide for a deduction in computing taxable income where a taxpayer has included an amount in his income for the year under subsection 147(10.4) of the Act. This subsection deals with the disposition by a taxpayer of employer shares that had previously been received by him as part of a single payment on his withdrawal from a deferred profit sharing plan. The permitted deduction is one-half the amount so included in income. The amendment to the effective date of this paragraph as enacted in Bill C-84 provides that it is applicable with respect to shares acquired on terminations of interests in deferred profit sharing plans occurring after May 23, 1985.

Deferred Profit Sharing Plans

ITA
147(10.4)

Clause 78

Section 147 of the Act deals with deferred profit sharing plans. Subsection 147(10.4), as enacted in Bill C-84, provides that a taxpayer who receives employer shares as part of a single payment on his withdrawal from the plan, his retirement or his death must include in income in the year he disposes of the shares the excess of the fair market value of the shares on the date he acquired them over their cost. Subsection 147(10.4) is applicable only where an election in respect of the shares has been made under subsection 147(10.1) of the Act. The amendment to the effective date of application of

subsection 147(10.4), as enacted in Bill C-84, is relieving in nature and provides that it is applicable with respect to terminations of interests in deferred profit sharing plans occurring after May 23, 1985.

Election by Legal Representative

ITA
164(6)

Clause 79

Subclause 90(15) of Bill C-84 provided the effective date for amendments made in that Bill to subsection 164(6) of the Act. That subsection allows the legal representative of a deceased taxpayer to elect to have capital losses and terminal losses incurred in the estate's first taxation year reported in the deceased taxpayer's return for the year of death. The subsection requires an amended return to be filed for the deceased taxpayer for the year of death in order to make the computations required under section 110.6 for the purposes of computing the deceased taxpayer's capital gains exemption. The amendments in this clause ensure that the amendments to subsection 164(6), as enacted in Bill C-84, are applicable with respect to deaths occurring after December 31, 1984.

Appendix I

Draft Income Tax Regulations

1. The *Income Tax Regulations* are amended by adding thereto, immediately after section 4603 thereof, the following heading and section:

"PRESCRIBED EXPENDITURE FOR QUALIFIED CANADIAN EXPLORATION EXPENDITURE

4604.(1) In this section,

"joint exploration corporation" has the meaning assigned by paragraph 66(15)(g) of the Act;

"principal business corporation" has the meaning assigned by paragraph 66(15)(h) of the Act;

"shareholder corporation" has the meaning assigned by paragraph 66(15)(i) of the Act; and

"well" means an exploratory probe or an oil or gas well.

(2) For the purposes of the definition "qualified Canadian exploration expenditure" in subsection 127(9) of the Act, the prescribed expenditure of a taxpayer for a taxation year is the aggregate of all amounts each of which is the amount, if any, by which

(a) his specified expenses for the year in respect of a well

exceed

(b) his base amount at the end of the year in respect of the well.

(3) For the purposes of this section, the specified expenses of a taxpayer for a taxation year in respect of a well that is an exploratory probe is the aggregate of all expenses that

(a) would be Canadian exploration expenses of the taxpayer by reason of any of subparagraphs 66.1(6)(a)(i), (iv) and (v) of the Act if the references in subparagraphs 66.1(6)(a)(iv) and (v) and the Act to "any of subparagraphs (i) to (iii.1)" were read as references to "subparagraph (i)";

(b) were incurred in the year, after November 1985 and before 1991;

(c) were incurred in the drilling or completing of the exploratory probe or in building a temporary access road to or preparing the site of the probe; and

(d) are not non-qualifying expenses of the taxpayer.

(4) For the purposes of this section, the specified expenses of a taxpayer for a taxation year in respect of a well that is an oil or gas well is the aggregate of all expenses that

(a) would be Canadian exploration expenses of the taxpayer by virtue of any of subparagraphs 66.1(6)(a)(ii) to (ii.2), (iv) and (v) of the Act if the references in subparagraphs 66.1(6)(a)(iv) and (v) of the Act to "subparagraphs (i) to (iii.1)" where read as references to "subparagraphs (ii) to (ii.2)";

(b) were incurred in the year, after November 1985 and before 1991 in respect of the oil or gas well; and

(c) are not non-qualifying expenses of the taxpayer.

(5) For the purposes of subsections (3) and (4), a non-qualifying expense of a taxpayer is an expense that

(a) may reasonably be regarded as having been incurred as consideration for services to be rendered after 1990 or property that cannot reasonably be considered to be for use by him before 1991;

(b) is or is to be renounced by the taxpayer at any time under subsection 66(10.1) or (12.6) of the Act;

(c) is or was a Canadian exploration and development overhead expense within the meaning of section 1206 of the taxpayer, of a partnership of which the taxpayer was a member or of a joint exploration corporation of which the taxpayer was a shareholder corporation;

(d) is an eligible expense within the meaning of the *Petroleum Incentives Program Act* or the *Petroleum Incentives Program Act* Chapter P-4.1 of the Statutes of Alberta 1981 in respect of which, or in respect of part of which, the taxpayer, a partnership of which the taxpayer was a member, a joint exploration corporation of which the taxpayer was a shareholder corporation or a principal business corporation of which the taxpayer was a shareholder, has received, is deemed to have received, is entitled to receive or may reasonably be expected to receive an incentive under either of those Acts or under the *Petroleum and Gas Revenue Tax Act*; or

(e) was included in determining the specified expenses of any other taxpayer for a taxation year.

(6) For the purposes of this section, the base amount of a taxpayer at the end of a taxation year in respect of a well is the amount, if any, by which his threshold amount in respect of the well exceeds the aggregate of

(a) all amounts that would have been his specified expenses for any taxation year in respect of the well if

(i) the references in paragraphs (3)(b) and (4)(b) to "after November 1985 and before 1991" were read as "after March 1985 and before December 1985", and

(ii) subsection (5) were read without reference to paragraph (d) thereof; and

(b) all amounts that would be included in determining his specified expenses for any preceding taxation year in respect of the well if subsection (5) were read without reference to paragraph (d) thereof.

(7) For the purposes of this section, the threshold amount of a taxpayer in respect of a well is

(a) where no agreement has been filed with the Minister under subsection (8) in respect of the well, $5,000,000; and

(b) where an agreement has been filed with the Minister under subsection (8) in respect of the well, the amount, if any, allocated to the taxpayer under the agreement.

(8) For the purposes of this section, where the aggregate of all expenses in respect of a well, each of which

(a) would be a specified expense of a taxpayer in respect of the well if subsection (5) were read without reference to paragraph (d) thereof, or

(b) would be a specified expense of a taxpayer in respect of the well if

(i) the references in paragraphs (3)(b) and (4)(b) to "in the year, after November 1985 and before 1991" were read as "after March 1985 and before December 1985", and

(ii) subsection (5) were read without reference to paragraph (d) thereof

exceeds $5,000,000, all taxpayers who have incurred those expenses or to whom any of those expenses have been renounced under subsection 66(10.1) or (12.6) of the Act may file with the Minister an agreement in writing in prescribed form in respect of the well allocating amounts to some or all of those taxpayers if

(c) the amount allocated to each taxpayer does not exceed the total of such expenses that were incurred by him in respect of the well, and that are not to be renounced by him under subsection 66(10.1) or (12.6) of the Act to any other person, and

(d) the aggregate of all amounts so allocated is not less than $5,000,000.

(9) For the purposes of this section, where

(a) the drilling of a well (in this subsection referred to as the "abandoned well") is abandoned not because of the results obtained but because of geological or mechanical difficulties and the drilling of a new well (in this subsection referred to as the "new well") is commenced, and

(b) having regard to all the circumstances, including the lapse of time between the abandonment of the abandoned well and the commencement of the new well and the proximity of the sites of the wells, it is reasonable to regard the new well as a replacement for the abandoned well,

the abandoned well and the new well shall be deemed to be one well.

(10) For the purposes of this section, where an expense of a joint exploration corporation is deemed by subsection 66(10.1) or (10.2) of the Act to be an expense of a shareholder corporation of the joint exploration corporation, the shareholder corporation shall be deemed to have incurred the expense at the time it was incurred by the joint exploration corporation.

(11) For the purposes of this section, where an expense of a principal business corporation is deemed by subsection 66(12.61) or (12.63) of the Act to be an expense of a shareholder of the corporation, the shareholder shall be deemed to have incurred the expense at the time it was incurred by the corporation.

(12) For the purposes of this section, where a Canadian development expense of a taxpayer is, under subsection 66.1(9) of the Act, deemed to be a Canadian exploration expense of the taxpayer, the taxpayer shall be deemed to have incurred the Canadian exploration expense at the time the expense was in fact incurred."

2. Section 1 is effective after November 30, 1985.

Appendix II

Draft Income Tax Regulation

1. The *Income Tax Regulations* are amended by adding thereto the following Part:

"PART LXXIII

CARVED-OUT PROPERTY EXCLUSION

7300. For the purposes of paragraph (e) of the definition of "carved-out property" in subsection 209(1) of the Act, a prescribed property is a property of the taxpayer that is

(a) any right, licence or privilege to prospect, explore, drill or mine for minerals (other than bituminous sands deposit, oil sands deposit and oil shale deposit) in a mineral resource in Canada;

(b) any rental or royalty computed by reference to the amount or value of production of minerals (other than bituminous sands deposit, oil sands deposit and oil shale deposit) from a mineral resource in Canada;

(c) any real property in Canada the principal value of which depends upon its mineral resource content (other than bituminous sands deposit, oil sands deposit and oil shale deposit), or

(d) any right to or interest in any property described in any of paragraphs (a) to (c)."

2. Section 1 is applicable to property acquired after July 19, 1985.

Appendix III

Draft Income Tax Regulation

1. (1) Paragraph (e) of Class 34 of Schedule II to the *Income Tax Regulations* is amended by deleting the word "or" at the end of subparagraph (iii) thereof, by adding the word "or" at the end of the subparagraph (iv) thereof and by adding thereto the following subparagraph:

> "(v) acquired after February 25, 1986 and that is a fixed location device that is a wind energy conversion system designed to produce electrical energy consisting of a wind driven turbine, generating equipment and related equipment including control and conditioning equipment, support structures, a powerhouse complete with equipment ancillary thereto and transmission equipment, but not including distribution equipment, equipment designed to store electrical energy and a property included in Class 10 or 17,".